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Supreme Court, U.S.
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In The

Supreme Court of the United States

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

PETITION FOR A WRIT OF *CERTIORARI*

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QUESTION PRESENTED

Whether the decision of the Supreme Judicial Court of Massachusetts, in conflict with the decisions of other state courts and the precedent of this Court, violates the Commerce Clause by permitting a State to tax the income of an out-of-state corporation that does not maintain a physical presence in the taxing State.

PARTIES TO THE PROCEEDING

The parties are as stated in the caption.

RULE 29.6 CORPORATE DISCLOSURE STATEMENT

For the years at issue in this dispute (the fiscal years ending January 31, 1997 through January 31, 2001), petitioner Geoffrey, Inc. was wholly owned by TRU, Inc., which is a wholly owned subsidiary of Toys "R" Us, Inc.

In 2008, Geoffrey, Inc. was converted into a single member limited liability company. Geoffrey, LLC currently is a wholly owned subsidiary of Geoffrey Holdings, LLC. Geoffrey Holdings, LLC is a wholly owned subsidiary of Toys "R" Us-Delaware, Inc. Toys "R" Us-Delaware, Inc. is a wholly owned subsidiary of Toys "R" Us, Inc.

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PETITION FOR A WRIT OF *CERTIORARI*

Petitioner Geoffrey, Inc. respectfully petitions for a writ of *certiorari* to review the judgment of the Supreme Judicial Court of Massachusetts.

OPINIONS BELOW

The opinion of the Supreme Judicial Court for the Commonwealth of Massachusetts (App., *infra*, 1a-18a) is reported at 453 Mass. 17 (2009). The appeal was transferred from the Appeals Court by order (App., *infra*, 19a-20a) granting application for direct review. The decision, findings of fact, and report of the Massachusetts Appellate Tax Board (App., *infra*, 21a-46a), are unreported.

JURISDICTION

The Supreme Judicial Court of Massachusetts entered its judgment on January 8, 2009.

This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS INVOLVED

Article I, Section 8, clause 3 of the United States Constitution provides: "The Congress shall have Power * * * [t]o regulate Commerce * * * among the several States * * *."

The relevant portions of the Massachusetts general laws and regulations are set forth at App., *infra*, 47a-124a.

INTRODUCTION

The question presented involves one of the most significant constitutional state tax issues currently being litigated in the state courts. It is an issue of great magnitude that has hopelessly divided state courts around the Nation, and it is worth billions of dollars annually to thousands of businesses worldwide, both large and small—from owners of intellectual property such as petitioner, to credit card companies, to authors earning royalties, to music publishers, to software companies, and to many more.

In these challenging financial times, States are mired in red ink and are, with alarming frequency, dramatically expanding their tax base without regard to constitutional limitations, in order to extract tax revenues from out-of-state corporations that do not have even the slimmest of reeds connecting them to the taxing State. Oftentimes, this tax revenue falls within the jurisdiction of another State. In the ruling below, Massachusetts has become the latest State to impose income-based taxes on out-of-state corporations even when they do not maintain a physical presence in the taxing State.

In order to uphold application of the Massachusetts tax against out-of-state corporations

without a physical in-state presence, the Massachusetts Supreme Judicial Court had to distinguish *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992), and hold that the prohibition of *Quill* against state taxation on out-of-state corporations unless they have an in-state physical presence applies only to sales and use tax collection, *i.e.*, taxes on buyers that are collected by the out-of-state corporation and remitted to the State. The Massachusetts court concluded that, notwithstanding *Quill*, Massachusetts may tax the income of an out-of-state corporation such as petitioner Geoffrey even though Geoffrey does not maintain a physical presence in the Commonwealth of Massachusetts, because the tax is based on royalties that Geoffrey receives from the use by others in Massachusetts of Geoffrey's intellectual property. This ruling by the Massachusetts court relied on the rationale set forth in its decision rendered the same day in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), *petition for cert. filed*, (U.S. Mar. 18, 2009) (No. 08-1169), where the court upheld the validity of applying Massachusetts' financial institutions excise tax to out-of-state credit card businesses that similarly do not maintain any physical presence in Massachusetts, but receive income from in-state credit card customers. The state court adopted an "elastic" nexus test that allows State taxation of an out-of-state corporation when the out-of-state corporation receives income from an in-state entity. App., *infra*, 3a.

The ruling of the Massachusetts' court cannot be reconciled with *Quill*, where this Court reaffirmed the longstanding constitutional requirement in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), that the substantial nexus between a taxing State and an out-of-state corporation being taxed, which is required to satisfy the Commerce Clause, can be met only if the out-of-state corporation has a physical presence in the taxing State. Moreover, irrespective of whether this Court believes the instant dispute is governed by *Quill* and *Bellas Hess*, this significant constitutional question should not remain unanswered by this Court.

The recent twin rulings in this case and *Capital One* by the Supreme Judicial Court of Massachusetts join a growing list of state appellate court decisions that have reached divergent conclusions on this issue, in numerous contexts, because of the lack of a decision from this Court. Thus far, approximately *one-third* of all the States in the Nation, 16 in total, have examined *Quill* and *Bellas Hess* and have come to their own view of the federal constitutional question. Three of those States—Tennessee, Michigan, and Texas—have concluded (correctly, in our view) that a taxing State may not, consistent with the Commerce Clause, impose on an out-of-state corporation the State's income or franchise taxes—*i.e.*, direct taxes on the corporation—unless the out-of-state corporation maintains a physical presence in the taxing State. And the appellate courts of 13 other States—Illinois, Louisiana, Maryland, New Jersey,

New Mexico, North Carolina, Ohio, Oklahoma, South Carolina, Washington, West Virginia, Wyoming and now Massachusetts—have come to a different conclusion. Those courts have held that the constitutionally required substantial nexus between the taxing State and the out-of-state corporation can be satisfied by a mere and amorphous economic connection to the taxing jurisdiction, without any in-state physical presence.[1]

Regardless of which side of the dispute is correct, it is now clear that this entrenched conflict in the state courts will not resolve itself absent this Court's intervention. No state court we cite that has decided this issue, one way or the other, has revisited the question presented and switched sides in the dispute.

Moreover, Congress has given no indication in the nearly two decades since *Quill* was decided, that it intends to follow up on this Court's suggestion in *Quill* that this is a question "that Congress may be better qualified to resolve." *Quill*, 504 U.S. at 318.

Accordingly, corporations that engage in interstate commerce involving numerous States in which they do not maintain a physical presence are left with an intolerable patchwork of inconsistent state laws concerning the scope of state tax jurisdiction under the Commerce Clause. And state taxing authorities in

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[1] In addition, many administrative, trial and tax court decisions on the question have been issued by other States, some of which are still subject to appellate review.

different States currently are bound by different interpretations of the federal constitutional limitations on state taxation of out-of-state corporations. This should not be the case, particularly for an issue as important as this. This constitutional question is worth billions of dollars annually. And absent this Court review, the state courts will continue to inconsistently decide who—the out-of-state corporation such as petitioner or the state taxing authority—is entitled to this money.

There is no reason for this Court to defer resolution of this conflict in the state courts. No better vehicles will present themselves than the twin rulings of the Supreme Judicial Court of Massachusetts in the instant case and the *Capital One* case. They provide this Court the opportunity to rule on the scope of the federal constitutional limitation on state taxation of the income of an out-of-state corporation in the context of different industries and different underlying factual scenarios. The petition for a writ of *certiorari* should be granted.

STATEMENT OF THE CASE

A. Constitutional, Statutory, And Regulatory Framework

1. More than forty years ago, this Court in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), confirmed the longstanding Commerce Clause doctrine that a State imposes an unconstitutional burden on interstate commerce

when it imposes tax collection and remittance responsibilities on an out-of-state corporation that lacks any physical presence in the taxing State. The *Bellas Hess* Court canvassed Supreme Court precedent back to 1939, and concluded that there is a "sharp distinction" between "sellers with retail outlets, solicitors, or property within a State, and those who do no more than communicate with customers in the State by mail or common carrier." *Bellas Hess*, 386 U.S. at 758. The Court explained that that distinction, which was the basis for those entities within the State being subject to State taxation and those outside of the State not being taxed, had "been generally recognized by the state taxing authorities," and "is a valid one." *Ibid.* The Court therefore "decline[d] to obliterate it." *Ibid.*

A decade after *Bellas Hess*, the Court set forth a general test for dormant Commerce Clause challenges to the exercise of state taxing power in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Under *Complete Auto*, a state tax will be upheld against a Commerce Clause challenge if the state tax: (1) "is applied to an activity with a substantial nexus with the taxing State"; (2) "is fairly apportioned"; (3) "does not discriminate against interstate commerce"; and (4) "is fairly related to the services provided by the State." *Id.* at 279.

In the years that followed *Complete Auto*, a number of state courts concluded that the "substantial nexus" requirement of *Complete Auto* had replaced the need under *Bellas Hess* for an

out-of-state corporation to have a physical presence in the taxing State in order for the state tax to be constitutionally applied. But this Court rejected that argument in *Quill Corporation v. North Dakota*. In *Quill*, the Court addressed again the Commerce Clause issue in a case involving the imposition on an out-of-state corporation of a use tax—*i.e.*, a tax effectively levied on the buyer but collected by the seller and remitted to the State. The *Quill* Court reaffirmed the central holding of *Bellas Hess* and ruled that the *Complete Auto* requirement that there be a "substantial nexus" between the taxing State and an out-of-state corporation can be met only where the corporation maintains a "physical presence" in the taxing State. *Quill Corp. v. North Dakota*, 504 U.S. 298, 314 (1992).

These rulings by the Court reflect core principles that undergird the Constitution, and which are reflected in the Commerce Clause, that a State may not regulate beyond its geographic borders into the boundaries of its sister States. As this Court has explained, "[i]n a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-778 (1992).

2. Respondent Massachusetts broadly taxes out-of-state corporations on income they derive from the in-state use by others of the out-of-state corporation's intangible property. And Massachusetts

does so regardless of whether the out-of-state corporation maintains a physical presence in Massachusetts.

The statutes of Massachusetts provide that "every foreign corporation, exercising its charter, or qualified to do business or actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay, on account of each taxable year" an excise tax. Mass. Gen. Laws ch. 63, § 39, 39(3)(a)(2), 39(3)(b). The stated purpose of that tax is "to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges and immunities derived by reason of the corporate form of existence and operation." *Id.* § 39(3).

Section 38(f) of the Massachusetts General Laws sets forth the rules for apportioning sales to Massachusetts in computing "net income determined to be taxable in accordance with the provisions of this chapter." That provision states that a sale is attributed to Massachusetts if it is derived from a sale "other than sales of tangible personal property" that occurs in Massachusetts "if 1. the income-producing activity is performed in this commonwealth; or 2. the income-producing activity is performed both in and outside this commonwealth and a greater portion of this income-producing activity is performed in this commonwealth than in

any other state, based on costs of performance." *Id.* § 38(f).

The Massachusetts Department of Revenue has promulgated regulations construing Section 38(f) that permit the apportionment to the State of the income received by an out-of-state corporation from its licensing of intangible property, such as trademarks, for use by licensees and rests on where and how much the licensee uses the property:

> Gross receipts from the licensing of intangible property are attributable to Massachusetts if the property is used by the licensee solely in Massachusetts. If the licensee uses the intangible property in more than one state, the gross receipts from the licensing are attributable to Massachusetts if the use of property by the licensee in Massachusetts exceeds its use of the property in any other one state.

830 Mass. Code Regs. § 63.38.1(9)(d)(3)(c) (2001).

The Massachusetts Department of Revenue has issued a directive addressing when use of intangible property by another in the State can subject to state taxation an out-of-state corporation who licensed the property. Directive 96-2 provides:

> A foreign corporation's intangible property used within Massachusetts will subject that corporation to corporate excise when:
>
> 1. The intangible property generates, or is otherwise a source of, gross receipts within

> the state for the corporation, including through a license or franchise; and
>
> 2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and
>
> 3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimus.

Mass. Dep't of Revenue Directive 96-2.

B. Factual Background[2]

1. Petitioner Geoffrey, Inc. was a Delaware corporation formed in 1984 as a wholly-owned subsidiary of Toys "R" Us, Inc. Petitioner owned intellectual property in the form of trademarks, tradenames and service marks which it licensed to third parties and other legal entities, including to Toys "R" Us-Mass, Inc. (TRUMI) and Baby Superstore, Inc.

TRUMI operated Toys "R" Us retail toy stores and Kids "R" Us retail children's clothing stores in Massachusetts during the fiscal years at issue. App.,

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[2] The facts recited in this Petition are taken primarily from the stipulated factual record; no material facts in this case were in dispute. Unless stated to the contrary, the facts relate to the tax years at issue, which are Geoffrey's fiscal years that ended January 31, 1997 through January 31, 2001.

infra, 26a. Baby Superstore, Inc., beginning with the fiscal year ended January 31, 1998, operated Babies "R" Us retail stores throughout the country, including three in Massachusetts, through its Babies "R" Us division. App., *infra*, 28a. Neither TRUMI nor Baby Superstore, Inc., are parties in the instant matter.

2. Respondent did not dispute that petitioner was formed for valid business purposes and had economic substance. Petitioner had no physical presence in Massachusetts. Petitioner does not own or maintain any offices, employees, or real or tangible personal property in Massachusetts. App., *infra*, 28a.

Petitioner's business activities were carried out through its board of directors which met annually outside of Massachusetts, and by support services performed in New Jersey, not Massachusetts, by Toys "R" Us for which petitioner paid arm's length rates,[3]

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[3] Respondent does not dispute that the payments made between the related companies, including royalties, were at arm's length rates. An independent tax tribunal held that the license between Geoffrey and another one of its licensees was at arm's length rates. *In re Toys "R" Us-NYTEX, Inc.*, No. TAT(E) 93-1039 (GC), 2004 N.Y. City Tax LEXIS 11 (N.Y.C. Tax App. Trib., Jan. 14, 2004), *aff'g*, No. TAT(H) 93-1039 (GC), 1999 N.Y. City Tax LEXIS 31 (N.Y.C. Tax App. Trib., Aug. 4, 1999). Further, in that case, the administrative law judge concluded that: "Geoffrey was created for several valid business purposes, including but not limited to owning and protecting the existing Toys 'R' Us trademarks and trade names; establishing and registering new trademarks and trade names; licensing those trademarks and trade names to both related and unrelated entities; and defending the integrity of the trademarks in

(Continued on following page)

and with the advice of New York-based trademark counsel. App., *infra*, 26a-28a. The license agreement between petitioner and TRUMI was executed outside of Massachusetts and during the years at issue petitioner did not use any state or federal courts in Massachusetts. App., *infra*, 27a-28a, 8a n.7.

3. TRUMI and Baby Superstore, Inc., conducted business in Massachusetts and filed Massachusetts corporation excise tax returns. Both TRUMI and Baby Superstore, Inc., claimed deductions for the royalties paid to Geoffrey.

Based on its audit of TRUMI, respondent began a nexus investigation of petitioner. On January 28, 2003, relying on its Directive 96-2, which provides that an out-of-state corporation is subject to Massachusetts' corporate excise tax in almost any circumstance where the out-of-state corporation's intangible property is used by another in Massachusetts with profit-seeking intent, respondent issued a Notice of Assessment against petitioner which, as revised by stipulation, imposes a tax of $1,257,793 with interest of $567,101. App., *infra*, 24a, 7a n.6. The notice also imposed late filing, late

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litigation with third parties. Geoffrey paid its own expenses, including fees to unrelated law firms and accounting firms. The credible testimony and evidence demonstrate not only that it was anticipated that Geoffrey would realize a profit from its licensing activities, apart from any tax benefit, but that in fact Geoffrey did realize such a profit." 1999 N.Y. City Tax LEXIS 31.

payment, and underpayment penalties of an additional $631,541. App., *infra*, 7a n.6.

C. Proceedings Below

1. Petitioner sought review of the assessment to the Massachusetts Appellate Tax Board, which rejected the appeal. The Tax Board concluded that Geoffrey's reading of *Quill* was too "broad" and that "neither * * * Supreme Court nor Massachusetts precedent supports the proposition that physical presence is required to impose an income-based tax." App., *infra*, 40a (citation omitted).

2. Petitioner filed an appeal with the Massachusetts Appeals Court and an application for direct appellate review with the Supreme Judicial Court of Massachusetts. App., *infra*, 1a. The Supreme Judicial Court granted the application and transferred the case to its jurisdiction. App., *infra*, 19a-20a. The court also granted a direct application for review in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), *petition for cert. filed*, (U.S. Mar. 18, 2009) (No. 08-1169), to address the same question of whether the State's imposition of the financial institution excise tax on out-of-state corporations is constitutionally limited to those corporations that maintain a physical presence in the State and, therefore, meet the constitutional nexus requirement. Both the instant case and the *Capital One* case were argued before the Supreme Judicial Court on October 7, 2008.

3. The Massachusetts Supreme Judicial Court affirmed the Tax Board in both cases.

In the instant case, the court relied heavily on its ruling issued the same day in *Capital One*. The court held that "substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer." App., *infra*, 11a. The court explained it was "join[ing] other jurisdictions that have considered the physical presence issue in the context of intangible property and have upheld the imposition of income-based tax assessments." *Ibid.* Even though the court acknowledged that the licenses with TRUMI and Baby Superstore, Inc., "permitted *those* entities to use the trademarks exclusively in Massachusetts," the court suggested that the licensee's activities were attributable to petitioner due to (1) the purported "encourage[ment to] Massachusetts customers to shop at Toys 'R' Us, Kids 'R' Us, and Babies 'R' Us through an *implicit* promise, manifested by the trademarks, that the products at those stores would be of good quality and value"; (2) petitioner's purported reliance on employees of TRUMI to "maintain a positive retail environment"; and (3) petitioner's quality control of licensed products to "maintain its positive reputation with Massachusetts customers." App., *infra*, 13a (emphasis added). But the court's conclusion that petitioner had a substantial nexus to Massachusetts due to its alleged "business activities" which resulted in "substantial

profits," was based at bottom on petitioner's out-of-state licensing of intangible property that generated income related to their use by the licensees in Massachusetts.

REASONS FOR GRANTING THE PETITION

REVIEW IS NECESSARY BECAUSE THE STATES ARE HOPELESSLY DIVIDED OVER WHETHER A STATE CAN TAX THE INCOME OF AN OUT-OF-STATE CORPORATION THAT DOES NOT MAINTAIN A PHYSICAL PRESENCE IN THE TAXING STATE

A. Sixteen State Courts Have Weighed In On The Conflict Regarding Whether This Court's Longstanding Requirement Of *Bellas Hess* And *Quill*, That A State May Tax An Out-Of-State Corporation Only If The Corporation Maintains A Physical Presence In The Taxing State, Applies To Income Taxes

There is a mature, well-recognized, and entrenched split of authority among the state courts on the question of whether the Commerce Clause prohibits the imposition by a State of income taxes on an out-of-state corporation that does not maintain any physical presence in the taxing State.

1. The decision below conflicts directly with the state appellate court rulings in Tennessee, Michigan and Texas.

The Tennessee court in *J.C. Penney National Bank v. Johnson*, held that Tennessee could not tax

the corporate earnings of out-of-state corporations that had no physical presence in Tennessee. The court explained that no valid distinction could be made for Commerce Clause purposes between such an income-based tax and the sales and use taxes at issue in *Bellas Hess* and *Quill*. The Tennessee court thus held that, "[w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case." *J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 839 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000).

The Michigan court, in *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. Ct. App. 1993), likewise stated, in a case involving a single business tax, that "after *Quill*, it is abundantly clear that" there must be "a physical presence within a target state to establish a substantial nexus to it." *Id.* at 377.

The Texas court, in *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000), adhered to *Quill*'s reasoning, and held that Texas cannot impose on an out-of-state corporation, that does not maintain a physical presence in the State, the State's franchise tax, *i.e.*, a tax on the privilege of doing business in the State. The Texas court explained that, "[w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause." *Id.* at 300. The Texas court held that, where a "corporation conducts its activity solely through

interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax." *Ibid.*

2. On the other side of the legal divide, the Supreme Judicial Court of Massachusetts has joined the appellate courts of Illinois, Louisiana, Maryland, New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, South Carolina, Washington, West Virginia, and Wyoming in holding that States may impose income and franchise taxes on an out-of-state corporation even though the corporation does not maintain any physical presence in the State. Most of these courts have acknowledged that their decisions depart from the precedent in other States.

The New Jersey Supreme Court recently declared that "[s]ince the Court decided *Quill*, a split of authority has developed regarding whether the Supreme Court's holding was limited to sales and use taxes." *Lanco, Inc. v. Director, Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007). The New Jersey court then concluded, erroneously in our view, that "the better interpretation of *Quill* is the one adopted by those states that limit the Supreme Court's holding to sales and use taxes." *Ibid.*

A divided West Virginia Supreme Court immediately followed the New Jersey court's *Lanco* ruling in *Tax Commissioner v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006). The West Virginia court also acknowledged the disagreement among the

state courts as to whether the physical presence requirement articulated in *Quill* applies to income and franchise taxes, and that that issue was a "major question left open by the Supreme Court's opinion." *Id.* at 231. In "reject[ing]" the Tennessee *J.C. Penney* court's reasoning requiring an out-of-state corporation to have a physical presence in the taxing State, the West Virginia court held that the "significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." *Id.* at 234.[4]

Several other state appellate courts similarly acknowledge the conflict among the courts in express terms. *See Bridges v. Geoffrey, Inc.*, 984 So.2d 115, 127 (La. Ct. App. 2008) (rejecting *Quill*'s physical presence requirement and describing the decisions of the Tennessee and Texas cases as not "persuasive"); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Ct. App. 2005) (rejecting *Quill*'s physical presence requirement and attempting to distinguish the Tennessee and Texas decisions); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 196 n.9 (N.C. Ct. App. 2004) (rejecting *Quill*'s physical presence requirement for income taxation and attempting to distinguish the

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[4] This conclusion by the West Virginia court was strongly disputed by the dissent. The dissent emphasized that "[t]he jurisprudential reality is that the United States Supreme Court has never held in any state tax case that the nexus requirements of the Commerce Clause can be satisfied in the absence of a taxpayer's physical presence in the taxing state." *Id.* at 239 (Benjamin, J., dissenting).

Tennessee court's *J.C. Penney* decision); *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1028 (Wash. Ct. App. 2001) (rejecting *Quill*'s physical presence requirement and noting that the taxpayers "correctly argue that some state courts have extended the physical presence rule").

In addition, a number of other state courts have held, without explicitly recognizing the conflict, that "the taxpayer need not have a tangible, physical presence in a state for income to be taxable there." *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993); *see also Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996) ("There is no indication in *Quill* that the Supreme Court will extend the physical-presence requirement to cases involving taxation measured by income derived from the state."); *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) (noting that "*Bellas Hess* and *Quill* * * * created [a] specialized jurisprudence" applicable to "sales or use tax case[s]"); *Kmart Props., Inc. v. Taxation & Revenue Dep't*, 131 P.3d 27, 35 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22, 35-36 (N.M. 2005) (same); *Comptroller of the Treasury v. Syl, Inc.*, 825 A.2d 399, 415-416 (Md. 2003) (same); *Borden Chems. & Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 80-81 (Ill. Ct. App. 2000) (same).

3. The fact that the Tennessee, Michigan, and Texas decisions do not come from state courts of last resort does not, in any way, lessen the adverse

consequences of the conflict in the state courts and does not undermine the need for review by this Court.

As a matter of state procedural law, the Tennessee Supreme Court's denial of further review in *J.C. Penney* approved and adopted the reasoning of the state appellate court when it denied review. *See State v. Cawood*, 134 S.W.3d 159, 164 n.6 (Tenn. 2004) (when the Tennessee Supreme Court "denies a writ of *certiorari*, the Court takes jurisdiction and makes a final disposition of the case by approving the final decree of the intermediate court").

Likewise, under state procedural law, the Michigan appellate decision is binding precedent throughout that State. *See Tebo v. Havlik*, 343 N.W.2d 181, 185 (Mich. 2004). In addition, the Michigan Department of Revenue has announced that it will adhere to the physical presence requirement in light of the *Guardian Industries* decision, *see J.W. Hobbs Corp. v. Revenue Div., Dep't of Treasury*, 706 N.W.2d 460, 463 (Mich. App. 2005).

Finally, Texas appellate procedure requires that Texas courts treat as binding precedent a decision such as the *Rylander* imposing the physical presence requirement. *See Messina v. State*, 904 S.W.2d 178, 181 (Tex. App. 1995).

Moreover, even if any of these decisions were subject to reconsideration by their own state courts, it is clear from the years that have passed from the dates of these rulings that these decisions are

entrenched. Not one of these state courts has revisited its prior conclusion.

B. The Decisions Of The Massachusetts Supreme Judicial Court Here And In *Capital One* Cannot Be Reconciled With This Court's Commerce Clause Precedent

Although the sheer breadth of the disagreement in the state courts alone should compel this Court to grant *certiorari* in the instant case, the petition also should be granted because the decision below cannot be reconciled with the Court's precedent.

1. This Court's Commerce Clause Holdings In *Quill* And *Bellas Hess* Govern This Case Because They Do Not Distinguish Between Different Types Of State Tax

a. Review is necessary here because, in attempting to avoid *Quill* and *Bellas Hess*, the court below and numerous other state courts have opined that this Court, and thus the Constitution, somehow distinguishes between sales and use taxes on the one hand and income and franchise taxes on the other. App., *infra*, 17a, 40a, 43a. But this Court's precedent does not support such a distinction because this Court has reasoned that the requirement under the Commerce Clause for a "substantial nexus" between a State and an out-of-state corporation is a necessary predicate "before *any* tax may be levied" by a State. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609,

626 (1981). *Quill* itself recognized that this Court's prior cases upholding state taxes have all "involved taxpayers who had a physical presence in the taxing State." *Quill*, 504 U.S. at 314.

Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), is not to the contrary. In that decision, this Court included the "substantial nexus" requirement as part of the four-prong test to determine whether the imposition of a state tax is permissible under the Commerce Clause, but no distinction was made between the types of state tax at issue. As such, even though *Complete Auto* addressed the constitutionality of a state use tax, (where the physical presence requirement of *Bellas Hess* and *Quill* would unquestionably apply), this Court relied equally on its franchise tax precedent. *See id.* at 285-287 (citing *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100, 101 (1975)).

In the years that have followed since *Complete Auto*, this Court has applied that four-prong analysis on several occasions to assess the constitutionality of state income taxes. *See, e.g. Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980); *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66 (1989); *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991); *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994). And this Court has rejected the argument, advanced by several States, that the "decision in *Complete Auto* undercut the *Bellas Hess* rule." *Quill*, 504 U.S. at 311-312.

The label that a State gives a tax cannot permit that tax to evade constitutional review. The *Complete Auto* Court recognized that redefining a tax one way or another will not result in a different analysis or result under the Constitution. "A tailored tax, *however accomplished*, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect on interstate commerce." *Complete Auto*, 430 U.S. at 288 n.15 (emphasis added). A court must "look[] past 'the formal language of the tax statute [to] its practical effect.'" *Quill*, 504 U.S. at 310 (quoting *Complete Auto*, 430 U.S. at 279) (second brackets in original). Accordingly, in discussing the Commerce Clause's substantial nexus requirement, this Court has routinely referred to cases involving sales and use taxes interchangeably with cases involving direct taxes such as income taxes, undermining the notion that respondent pressed below (and the state court adopted) that there are different substantial nexus requirements for different kinds of state taxes. *See, e.g.*, *National Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 555-559 (1977).

There is no logical reason that a State should be able to impose state income taxes on an out-of-state corporation that does not maintain a physical presence in that State when it cannot, under the Commerce Clause, impose state sales and use taxes on that out-of-state corporation.

b. Application of the physical presence requirement articulated in *Quill* and *Bellas Hess* to

state imposition of income taxes on out-of-state corporations is entirely consistent with the core principles that undergird the Commerce Clause. In declining to overrule *Bellas Hess*, the *Quill* Court reaffirmed that the Commerce Clause was intended to address "structural concerns about the effects of state regulation on the national economy" because, under the Articles of Confederation, "state taxes and duties [had] hindered and suppressed the interstate commerce." *Quill*, 504 U.S. at 312.

The economic nexus rationale set forth by the Massachusetts court below, as well as by some of the other state courts to have decided this issue, was plainly rejected by this Court in *Quill*. *See MBNA*, 640 S.E.2d at 241 (Benjamin, J., dissenting) (noting that this Court rejected the "economic exploitation nexus" arguments in *Bellas Hess* and *Quill*). In *Quill*, the State had argued that because the out-of-state corporation had derived significant revenues from in-state customers, the corporation should have paid tax to that State on that income. The State also argued that: (1) the out-of-state corporation received benefits from the taxing State; (2) such a corporation would be at a competitive advantage vis-à-vis in-state merchants who necessarily must collect the tax; and (3) the physical presence rule was rendered obsolete by the technological and economic changes of the late Twentieth Century. But this Court correctly concluded that none of these arguments in *Quill* justified a departure from the physical presence

requirement. And there is no reason why they should lead to a different result today merely because an income, rather than sales or use, tax is at issue.

Indeed, the ruling below, by cabining *Quill* and *Bellas Hess* to sales and use taxes only, has imposed a constitutional regime in which States can reach the very transactions the Constitution seeks to protect from state interference. As this Court has previously made clear, the economic burdens on interstate commerce posed by imposition of state income taxes on out-of-state corporations are actually greater than the consequences of sales and use tax collection obligations. *National Geographic*, 430 U.S. at 558. The state taxes invalidated in *Bella Hess* and *Quill* were not direct taxes on out-of-state corporations but, instead, were obligations to collect sales and use taxes from in-state customers. By contrast, income and franchise taxes are *direct* taxes imposed on the out-of-state corporation.

As such, it would make no sense for the administrative burden of a collection obligation for sales and use taxes to violate the Commerce Clause due to the absence of any physical presence by the out-of-state corporation, *see Quill*, 504 U.S. at 313 n.6, but for no such violation to occur where there is not only an administrative burden but also an immediate financial obligation of an income tax for what might amount to that same sale by the

out-of-state corporation that maintains no physical presence in the State.[5]

c. The physical presence requirement of *Bellas Hess* and *Quill* is supported not only in the context of sales and use taxes, but also with regard to income taxes, by basic federalism principles.

Although the modern economy may lack physical borders, States do not. In the years since *Quill*, this Court has consistently reaffirmed the constitutional limitations on a State's ability to regulate economic activity beyond its geographic border. *See, e.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 421 (2003); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 569-571 (1996); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 821-823 (1985); *see also Granholm v. Heald*, 544 U.S. 460, 472 (2005) (noting that the

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[5] Congress has mandated in 15 U.S.C. § 381 that there is a minimum standard for State imposition of net income tax that provides that no State may impose such a tax "on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person" are based solely on solicitations of orders in the State for sales of tangible personal property that are approved or rejected outside the State, and/or solicitations of such orders for the benefit of a customer. 15 U.S.C. § 381(a). States thus have targeted out-of-state corporations that earn income from customers located in their State or from intangible property used in their State, *e.g.*, businesses owning intellectual property, computer software firms, credit card businesses, music publishers, and service providers. Of course, Congress's imposition of a minimum standard says nothing about the constitutionality of the reach of the state tax to the situation presented here.

Commerce Clause was intended to "minim[ize]" the potential for "[r]ivalries among the States").

If the physical presence of a taxpayer in the taxing State becomes irrelevant to a State's power over the taxpayer, and a State is allowed to exert broad taxing authority solely on the basis of activity in commercial markets, then state regulatory power becomes effectively unmoored from the very feature of the State that gives it constitutional status—*viz.*, its sovereignty over a specified geographical area and those who come within it. For that reason, this Court has explicitly held that "[i]n a Union of 50 States, to permit each State to tax activities outside its borders would have drastic consequences for the national economy, as business could be subjected to severe multiple taxation." *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777-778 (1992).

2. Any Ambiguity In The Reach Of *Quill's* Constitutional Ruling Should Be Resolved By This Court And Not Left To A Disagreement Among The State Courts

a. Several state courts, including the court below, *see* App., *infra*, 43a; *Capital One*, 899 N.E.2d at 12, have limited *Quill* and *Bellas Hess* to sales and use taxes and have declined to apply that precedent to income taxes based upon the following observation in *Quill*:

> [A]lthough in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.

Quill, 504 U.S. at 317; *see also id.* at 314 ("Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule.").

Those statements do not, however, provide States with a justification to exclude income-based taxes from this Court's physical presence requirement. That is particularly true in light of this Court's longstanding precedents which do not impose different Commerce Clause tests depending upon the state tax at issue. *See* pages 22-27, *supra*.

Nevertheless, the disparate decisions of 16 state courts demonstrate that this language in *Quill* has created ambiguity. That provides yet another reason for this Court to grant this petition and clarify the implications of this dictum.

b. Even if this Court were to view the state courts that have refused to apply *Bellas Hess* and *Quill* to income taxes to be correct, it is for this Court to rule on the question. As Justice Scalia explained in

his opinion concurring in part and concurring in the judgment in *Quill*, "if a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [courts] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Quill*, 504 U.S. at 320 (Scalia, J., concurring in part and concurring in the judgment) (citation omitted).

Moreover, this Court's ruling on the question presented is necessary because the absence of this Court's intervention has led some state courts to believe that this Court has rejected the physical presence requirement for state income tax cases merely because the Court has denied *certiorari* in certain cases. *Praxair Technology, Inc. v. Director, Div. of Taxation*, No. 007445-05 (N.J. Tax Ct. June 27, 2007) (Order Granting Partial Summ. J.), *rev'd and remanded*, 404 N.J. Super. 287, 291 (N.J. Super. Ct. App. Div. 2008) (viewing this Court's denials of *certiorari* as "signaling" its decision on the merits of this issue).

3. A Bright-Line, Physical Presence Requirement Provides A Judicially Manageable Rule, Whereas An Economic Nexus Standard Would Be Unmanageable And Subject To Manipulation

The requirement that a State not impose state taxation on an out-of-state corporation unless that

corporation maintains a physical presence in the taxing State provides a principled and judicially manageable rule that "encourages settled expectations and, in doing so, fosters investment by businesses and individuals." *Quill*, 504 U.S. at 316.

One of the foremost experts in State taxation, Professor Richard D. Pomp, explained that the "physical presence is to be preferred to economic presence as a nexus standard" because it is "more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, more easily administered, and more compatible with the growth of electronic commerce." App., *infra*, 143a. An economic nexus standard, on the other hand, "is amorphous and easily malleable" and "is less a legal principle and more an invitation to chaos and multiple taxation." *Ibid.*

Indeed, the vagaries of the economic nexus test, as opposed to the physical presence test, are plainly demonstrated by the courts that have applied it. The Massachusetts court held that "substantial nexus" is an "elastic" test that purportedly "means a greater presence, both qualitatively and quantitatively, than the minimum connection between a State and a taxpayer that would satisfy a due process inquiry," yet in the State's view this elastic text can be satisfied by virtually any commercial arrangement with individuals or entities in the taxing State.

Capital One, 899 N.E.2d at 15; *see also* App., *infra*, 3a.[6]

West Virginia courts look to whether there is any significant "economic presence" in the State. *MBNA*, 640 S.E.2d at 234. And other state courts have similarly based their decisions on some amorphous threshold requirement of minimum economic or commercial activity directed at the taxing State. *General Motors*, 25 P.3d 1028-1029.

These nonstandards provide no guidance to the courts that must apply them or to the out-of-state corporations that must abide by them. And the flexible—*i.e.*, malleable—nature of these tests has been justified by the limitless rationale that those "who adopted the Commerce Clause lived in a world that is impossible for people living today to imagine" so that there must be "a fresh application of Commerce Clause principles tempered with healthy

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[6] The Massachusetts Department of Revenue Directive 96-2, on which the State relied in this case, finds a substantial nexus any time an out-of-state corporation's intangible property "generates gross receipts" through a "contract with an in-state company" and the presence of the "intangible property" and the out-of-state corporation's "activities with respect to that property" are "more than de minimis." Mass. Dep't of Revenue Directive 96-2. Under this standard, it is difficult to conceive of a circumstance where the use for profit in Massachusetts of intangible property owned by an out-of-state corporation would not in the State's view result in a substantial nexus that authorizes state taxation of the out-of-state corporation.

doses of fairness and common sense" to adapt to the modern world. *MBNA*, 640 S.E.2d at 236.

That rationale, rooted in the speed and scope of modern interstate commerce arrangements, is symptomatic of the problem with the economic nexus standard. It means that the Commerce Clause has become nugatory, because economic transactions no longer yield to State borders, so that a State can regulate any interstate commerce that involves a customer who lives within the taxing State, contrary to this Court's longstanding precedent.

C. The Continued Departure By State Courts And Taxing Authorities From The Physical Presence Requirement Has Severe Economic Implications

1. The Conflict In The State Courts Creates Economic Uncertainty On An Issue That Is Worth Billions Of Dollars Annually To Corporations Such As Petitioner And The States

The uncertainty caused by the continued proliferation of the now 16-State conflict in the state courts significantly hinders business planning and investment at a time our Nation can ill afford it. This issue affects all sorts of corporations—from petitioner, to the credit card companies in *Capital One*, to authors and music publishers, to software companies, and to many others. It is estimated to be worth billions of dollars annually. That means that until

this Court resolves this undecided constitutional issue, state courts will continue to divergently decide who—the State or the out-of-state corporation without a physical presence in the State—has a right to this money.

A corporation attempting to order its business affairs and determine in what States it can be subjected to state income and franchise tax currently is faced with the prospect of different conclusions in different States, depending not on any difference in the extent of the connection between the corporation and the State but, instead, on the difference in how the state courts may interpret the federal Constitution. Such uncertainty inhibits strategic business planning and investment and is extraordinarily costly. Reliance interests need to be respected and the clarity provided by *Quill* restored. Absent clear guidance from this Court, there is no reliable way for businesses to predict how far jurisdictions will assert taxation authority in the future, and whether such exercise of taxing authority will be upheld by the courts.

States have also begun to sustain the imposition of substantial, non-deductible and often unabateable penalties on out-of-state corporations that had relied (and continue to rely) on this Court's holdings in *Quill* and *Bellas Hess* that physical presence is a prerequisite for nexus under the Commerce Clause.

The need for clarity on this issue is particularly important in light of requirements for corporate

transparency. The Financial Accounting Standards Board Interpretation No. 48 (FIN 48), which is entitled Accounting for Uncertainty in Income Taxes, sets forth how a corporation must account for and disclose its income tax positions. In particular, FIN 48 requires a company to determine whether it is "more likely than not" that its positions would be upheld by the court of last resort. If it is not more likely than not that a position will be upheld, the corporation cannot recognize a benefit for such position in its financial statements. Financial Accounting Standards Board, *Accounting for Uncertainty in Income Taxes—An Interpretation of FASB Statement No. 109*, App. A, A2 (2008). Although the court of last resort on constitutional questions is this Court, some auditors are requiring that no benefit be taken on economic nexus positions due solely to the conflict on this issue in the State courts that has not yet been resolved by Congress or this Court. That results in profound consequences for the publicly reported financial health of a corporation, for shareholder value, and the ability to raise capital in this particularly uncertain economic time.

Although a remarkably large number of States have litigated this issue to completion, two thirds of the States have not yet conclusively weighed in on this issue. The likely continued litigation of the issue in these other States will not resolve the entrenched disagreement in the state courts, and it will continue to generate enormous—and enormously wasteful—litigation costs. *Cf. Quill*, 504 U.S. at 315

(noting that a clear rule establishing the boundaries of state taxation authority would "reduc[e] litigation concerning those taxes").[7]

2. The Economic Nexus Standard Has Adverse Global Implications

Tax jurisdiction is not just a national issue. Under most international tax treaties to which the United States is a signatory, the United States has agreed to tax foreign corporations only if they have a "permanent establishment" in the United States, which is normally defined as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." U.S. Model Income Tax Convention art. 5(1), Sept. 20, 1996. A foreign corporation thus is not subject to United States income tax unless it is physically present in this country. That "permanent establishment" requirement is widely used in the international arena because of its clarity, reliability, and fairness, which

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[7] In addition to statutory, regulatory, and other publicly announced economic nexus positions and cases pending before or decided by State administrative tribunals, there also is ongoing litigation in certain States that has not yet resulted in appellate court decisions. *See, e.g.*, *MBNA America Bank, N.A. v. Indiana Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax Ct. 2008) (case presenting same issue that has recently come out of the tax court in Indiana and likely to proceed to higher state court).

all are principles of tax policy that apply equally in the State tax arena.[8]

These treaties also are of particular concern because they generally do not limit the power of States and localities to impose taxes on foreign corporations. *See Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 196-197 (1983). Consequently, if the decision below is permitted to stand, a foreign corporation without a permanent establishment in the United States could find itself subject to tax by States that reject a physical presence requirement, even though the foreign corporation would not be subject to federal income tax. *Cf. Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 448 (1979) (noting that "a state tax on the instrumentalities of foreign commerce may impair federal uniformity in an area where federal uniformity is essential").

In addition to the practical problems that could arise (most State tax returns use federal income tax returns as their starting point in computing tax

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[8] The permanent establishment provision was introduced by the League of Nations in 1927 (*see Reports Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216M.85 1927 II (1927) (presenting Draft Bilateral Convention for the Prevention of Double Taxation)), and has been incorporated into virtually all international tax treaties ever since. *See generally* Gary D. Sprague & Rachel Hersey, *Permanent Establishments and Internet-Enabled Enterprises: The Physical Presence and Contract Concluding Dependent Agent Tests*, 38 Ga. L. Rev. 299 (2003).

liability), there would be an "enhanced risk of multiple taxation" and the United States would be prevented from "speak[ing] with one voice" with respect to international trade, which are considerations that must be addressed, in addition to the *Complete Auto Transit* tests, when foreign commerce is implicated. *See Container Corp.*, 463 U.S. at 185; *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 311 (1994) (citation omitted).

CONCLUSION

For the reasons set forth above, the petition for a writ of *certiorari* should be granted.

Respectfully submitted,

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March 2009

APPENDIX A

COMMONWEALTH OF MASSACHUSETTS

SUPREME JUDICIAL COURT
FOR THE COMMONWEALTH

AT BOSTON, 8 January 2009

IN THE CASE NO. SJC-10106

GEOFFREY, INC.

vs.

COMMISSIONER OF REVENUE

pending in the Appellate Tax Board
No. C271816-03-COR

ORDERED, that the following entry be made in the docket; viz., –

Decision of the Appellate Tax Board affirmed.

BY THE COURT,

/s/ Susan Mellen
Clerk
Supreme Judicial Court
For the Commonwealth

DATED: January 8, 2008

See opinion on file.

GEOFFREY, INC. *vs.*
COMMISSIONER OF REVENUE.

Suffolk. October 7, 2008. – January 8, 2009.

Present: Marshall, C.J., Ireland, Spina, Cowin, Cordy, & Botsford, JJ.

Appeal from a decision of the Appellate Tax Board.

The Supreme Judicial Court granted an application for direct appellate review.

Paul H. Frankel, of New York (*Maxwell D. Solet* with him) for the taxpayer.

Thomas A. Barnico, Assistant Attorney General, for Commissioner of Revenue.

SPINA, J. The present appeal is from a decision of the Appellate Tax Board (board) affirming the denial by the Commissioner of Revenue (commissioner) of an application by the taxpayer, Geoffrey, Inc. (Geoffrey), for the abatement of corporate excises assessed for the tax years ending January 31, 1997, through January 31, 2001. We granted Geoffrey's application for direct appellate review. At issue is whether, consistent with the commerce clause, art 1, § 8, of the United States Constitution,[1] the Commonwealth can impose a

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[1] The commerce clause authorizes Congress to "regulate Commerce . . . among the several States." Art. 1, § 8, of the United States Constitution.

corporate excise tax, pursuant to G. L. c. 63, § 39, on a foreign corporation[2] that does not have a physical presence in Massachusetts. In our decision in *Capital One Bank v. Commissioner of Revenue, ante* ___, ___ (2008) (*Capital One*), released today, we concluded that the constitutionality, under the commerce clause, of the Commonwealth's imposition of an income-based excise on an out-of-State entity is not determined by the "physical presence" test articulated in *Quill Corp. v. North Dakota,* 504 U.S. 298, 317-318 (1992) (*Quill*), but by the "substantial nexus" test articulated in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977) (*Complete Auto*). Our holding in *Capital One* is controlling with respect to Geoffrey's constitutional claim. For the reasons that follow, we now affirm the decision of the board.

The board found the following facts, based on the parties' stipulations of facts and the testimony and exhibits introduced at the hearing. See G. L. c. 58A, § 13 ("The decision of the board shall be final as to findings of fact"); *United Church of Religious Science v. Assessors of Attleboro,* 372 Mass. 280, 281 (1977).

On January 24, 1984, Geoffrey was incorporated in Delaware as a wholly owned subsidiary of Toys "R"

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[2] A "[f]oreign corporation" is defined as a "corporation, association, or organization established, organized or chartered under laws other than those of the commonwealth." G. L. c. 63, § 30(2).

Us, Inc. (Toys Inc.), a Delaware corporation.[3] Effective August 1, 1984, Toys Inc. transferred trademarks, trade names, and service marks (collectively, trademarks) to Geoffrey in exchange for stock. Included in this transfer were the "Toys 'R' Us" and "Kids 'R' Us" trademarks and the "Geoffrey" giraffe character logo. A 1991 appraisal by Arthur Andersen & Co. determined that the fair market value of the intellectual property owned by Geoffrey was $1.5 billion. Geoffrey's business activities consisted of licensing the trademarks to various Toys Inc. subsidiaries and affiliates for use in their retail operations throughout the United States. Geoffrey had no employees or offices in Massachusetts, and it owned no tangible property, real or personal, in this Commonwealth. The trademarks were registered with the United States Patent and Trademark Office.

Toys "R" Us-Mass, Inc. (TRUMI), was another subsidiary of Toys Inc. During the tax years at issue, TRUMI operated twenty-six Toys "R" Us and Kids "R" Us retail stores in the Commonwealth. Pursuant to a licensing agreement dated May 3, 1992, Geoffrey permitted TRUMI to use the "Toys 'R' Us" and "Kids 'R' Us" trademarks solely in Massachusetts in exchange for royalty payments to Geoffrey at a rate of three per cent of TRUMI's net sales at Toys "R" Us

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[3] For the first four tax years at issue, Geoffrey's principal place of business was in Wilmington, Delaware. On January 1, 2000, Geoffrey moved its principal place of business to Paramus, New Jersey.

stores, and two per cent of its net sales at Kids "R" Us stores. This agreement was made subject to the laws of Delaware. TRUMI filed Massachusetts corporate excise tax returns on a separate company basis, and it claimed a deduction for a portion of the royalties paid to Geoffrey.

In February, 1997, Geoffrey entered into a similar licensing agreement with Babies "R" Us, a division of Baby Superstore, Inc. (Baby Superstore), which was an affiliate of TRUMI, for the use of Geoffrey's "Babies 'R' Us" trademark. During the tax years at issue, Babies "R" Us operated three retail stores in the Commonwealth. Pursuant to this licensing agreement, Babies "R" Us paid Geoffrey royalties at a rate of one per cent of its net sales for the 1996 fiscal year, one and one-half per cent of its net sales for the 1997 fiscal year, and two per cent of its net sales for the remaining years of the agreement.

Geoffrey's trademarks appeared on signage, store displays, and product packaging at Massachusetts stores operated by TRUMI and Baby Superstore. The trademarks were intended to demonstrate to consumers that goods and services sold by licensees were of high quality and good value. Pursuant to the licensing agreements, Geoffrey had the right to review product samples and specifications, signs, labels, tags, packaging materials, advertising and sales promotion materials, catalogues, and pamphlets that displayed the trademarks. TRUMI and Baby Superstore agreed to comply with Geoffrey's

instructions to ensure that the trademarks did not become generic, which could adversely affect Geoffrey's interests in them. Geoffrey received over $33 million in royalty income from retail stores located in Massachusetts during the tax years at issue.[4]

Under a quality control, legal and treasury service Agreement dated February 3, 1996, Toys Inc. provided advice and assistance to Geoffrey with respect to investment opportunities, accounting matters, and licensing issues. In particular, Toys Inc. dedicated the services of an intellectual property specialist to the task of protecting Geoffrey's assets. Toys Inc. also employed regional and district managers with responsibilities for Massachusetts stores who could monitor the use of the trademarks in the Commonwealth and would bring store problems to the attention of appropriate officials. Reports from Toys Inc. explaining the results of its quality control activities were provided to Geoffrey. For its services, Toys Inc. was paid $300,000 annually. In addition, Geoffrey had access to State and Federal courts in Massachusetts to protect its interests in its

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[4] Geoffrey's annual royalty income from retail stores in the Commonwealth was as follows: $5,928,567, for the tax year ending February 1, 1997; $6,554,265 for the tax year ending January 31, 1998; $6,628,656 for the tax year ending January 30, 1999; $7,117,981 for the tax year ending January 29, 2000; and $7,423,420 for the tax year ending February 3, 2001.

trademarks and its entitlement to royalty payments under the licensing agreements.

During an audit of TRUMI in 2002, the Department of Revenue (department) discovered that Geoffrey had been receiving royalty income under the licensing agreement with TRUMI, but had not been filing corporate excise returns in Massachusetts.[5] On October 2, 2002, the department issued to Geoffrey a notice of failure to file corporate excise returns for the tax years at issue. In response, Geoffrey provided the department with unsigned, pro forma returns for the relevant years. On December 14, 2002, the department issued to Geoffrey a notice of intent to assess, which was subsequently revised on December 23, 2002. Approximately one month later, the department sent Geoffrey a notice of assessment for the tax years at issue in the amount of $3,143,445, consisting of $1,692,568 in corporate excise taxes, $645,008 in accrued interest, and $805,865 in penalties.[6] Geoffrey filed a timely application for abatement, claiming that it was not obligated to pay such taxes because it had no nexus with the Commonwealth. See G. L. c. 62C, § 37. On September

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[5] Similarly, separate royalty income paid to Geoffrey by Baby Superstore pursuant to its licensing agreement had not been reported to the department and would become part of the tax assessment.

[6] The parties' second supplemental stipulation of facts corrected the amount of the assessment to $2,456,435, consisting of $1,257,793 in corporate excise taxes, $567,101 in accrued interest, and $631,541 in penalties.

19, 2003, the commissioner denied the application, and Geoffrey appealed to the board pursuant to G. L. c. 62C, § 39.

In affirming the commissioner's denial of the abatement, the board stated that Geoffrey's business activities in Massachusetts constituted a "substantial nexus" with the Commonwealth that justified imposition of the corporate excises for the tax years at issue. In particular, the board based its determination on Geoffrey's purposeful efforts to reap economic benefits from the Commonwealth's retail marketplace by licensing the trademarks for use by TRUMI and Baby Superstore. The trademarks, the board pointed out, were used extensively by Toys "R" Us, Kids "R" Us, and Babies "R" Us stores in Massachusetts, and such use resulted in Geoffrey's receipt of substantial royalty income. The board also noted that Geoffrey retained the right to regulate use of the trademarks, and was afforded access to State and Federal courts in Massachusetts to protect its interests.[7] Consequently, the board concluded that the Commonwealth's assessment of corporate excise taxes on Geoffrey was constitutional under the Federal commerce clause. The board further stated that Geoffrey did not demonstrate that it had acted with reasonable cause in failing to file returns or pay corporate excises for the tax years at issue, and

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[7] Geoffrey points out that it did not use State or Federal courts in Massachusetts during the tax years at issue to protect its intellectual property rights.

therefore, Geoffrey was not entitled to abatement of the penalties assessed pursuant to G. L. c. 62C, § 33.[8]

A decision by the board will not be modified or reversed if the decision "is based on both substantial evidence and a correct application of the law." *Boston Professional Hockey Ass'n v. Commissioner of Revenue,* 443 Mass. 276, 285 (2005). We presume that a tax is constitutionally valid unless the party challenging it establishes its invalidity "beyond a rational doubt." *Andover Sav. Bank v. Commissioner of Revenue,* 387 Mass. 229, 235 (1982). While we give deference to the board's expertise in interpreting the tax laws of the Commonwealth, see *French v. Assessors of Boston,* 383 Mass. 481, 482 (1981), we apply our independent judgment as to both the law and the facts on constitutional issues. See *Opinion of the Justices,* 328 Mass. 679, 687 (1952).

Pursuant to G. L. c. 63, § 39, "every foreign corporation, exercising its charter, or qualified to do business or actually doing business in the

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[8] In its appeal to the Appellate Tax Board (board), Geoffrey also took issue with the apportionment of its income on the ground that it resulted in the taxation of extraterritorial values. General Laws c. 63, § 38, provides that the net income of a foreign corporation derived from business activity that is taxable both within and without the Commonwealth shall be apportioned in accordance with a specified statutory formula. The board concluded that the apportionment formula was calculated correctly with respect to Geoffrey's income. Geoffrey has not challenged this determination in the present appeal, so we need not consider it further.

commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay, on account of each taxable year, the [specified] excise." The Legislature has stated that the purpose of § 39 is to require foreign corporations to pay "for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges and immunities derived by reason of the corporate form of existence and operation." *Id.* In accordance with G. L. c. 62C, § 3, "[t]he commissioner may prescribe regulations and rulings, not inconsistent with law, to carry into effect the provisions of [G. L. c. 63, § 39], which regulations and rulings, when reasonably designed to carry out the intent and purposes of said provisions, shall be prima facie evidence of their proper interpretation." Pursuant to this authority, the commissioner promulgated 830 Code Mass. Regs. § 63.39.1 (1993), which "describes the circumstances under which a foreign corporation is subject to the tax jurisdiction of Massachusetts under [ ] G. L. c. 63, § 39." 830 Code Mass. Regs. § 63.39.1(1)(a). As is pertinent here, "a foreign corporation must file a return in Massachusetts and pay the associated excise if . . . the corporation owns property that is held by another in Massachusetts under a lease, consignment, *or other arrangement*" (emphasis added). 830 Code Mass. Regs. § 63.39.1(4)(d)(1). The licensing of the trademarks by Geoffrey to TRUMI and Baby Superstore would be one type of "other arrangement" that would subject Geoffrey to the corporate excise tax under G. L. c. 63, § 39.

That said, the thrust of Geoffrey's appeal is that, because Geoffrey had no physical presence in Massachusetts, the imposition of the corporate excise under § 39 violated the Federal commerce clause.[9] We disagree.

As we stated at the outset of this opinion, resolution of the physical presence issue under commerce clause analysis is governed by our decision in *Capital One, supra.* We now conclude that substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer. In reaching this conclusion, we join other jurisdictions that have considered the physical presence issue in the context of intangible property and have upheld the imposition of income-based tax assessments. See *Geoffrey, Inc. v. South Carolina Tax Comm'n,* 313 S.C. 15, 23-24, cert. denied, 510 U.S. 992 (1993) (licensing intangible property for use in taxing State and deriving income from such use established substantial nexus for imposition of income-based tax in conformity with commerce clause); *Bridges v.*

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[9] A State's ability to tax businesses operating in interstate commerce also is constrained by the due process clause of the Fourteenth Amendment to the United States Constitution. See *Capital One Bank v. Commissioner of Revenue, ante* ___, ___ n.14 (2008). Geoffrey does not challenge the imposition of the corporate excise tax on the ground that Geoffrey's purported "economic presence" in Massachusetts was insufficient to satisfy the "minimum contacts" standard of the due process clause.

Geoffrey, Inc., 984 So. 2d 115, 128 (La. Ct. App. 2008) (same); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632, 638-639 (Okla. Ct. App. 2005) (same). See also *Lanco, Inc. v. Director, Div. of Taxation*, 379 N.J. Super. 562, 573 (App. Div. 2005), aff'd, 188 N.J. 380, 383 (2006) (per curiam), cert. denied, 127 S. Ct. 2974 (2007) (concluding that State may constitutionally subject foreign corporation to business tax where corporation lacks physical presence in State but derives income from licensing agreement with company conducting retail operations in State); *Kmart Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 139 N.M. 177, 186 (Ct. App. 2001) (stating that "the use of KPI's marks within New Mexico's economic market, for the purpose of generating substantial income for KPI, establishes a sufficient nexus between that income and the legitimate interests of the state and justifies the imposition of a state income tax"), rev'd on other grounds, 139 N.M. 172 (2005); *A & F Trademark, Inc. v. Tolson*, 167 N.C. App. 150, 162 (2004), cert. denied, 546 U.S. 821 (2005) (concluding that where out-of-State company licenses trademarks to related in-State retail company, there exists substantial nexus with taxing State to satisfy commerce clause). See generally 1 J.R. Hellerstein & W. Hellerstein, State Taxation § 6.11 (3d ed. 2007) (exploitation of intangible property rights in State as basis for jurisdiction to tax out-of-State persons deriving income from such property). Contrast *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 299, 301 (Tex. Ct. App. 2000) (concluding that franchise tax based solely on

taxpayer's mere possession of license to do business in Texas was invalid, but not addressing whether royalty payments from licensing of intangibles were sufficient to satisfy substantial nexus test).

Here, Geoffrey engaged in business activities with a substantial nexus to Massachusetts during the tax years at issue. Geoffrey entered into contractual relationships, in the form of licensing agreements, with TRUMI and Baby Superstore and permitted those entities to use the trademarks exclusively in Massachusetts; Geoffrey encouraged Massachusetts consumers to shop at Toys "R" Us, Kids "R" Us, and Babies "R" Us through an implicit promise, manifested by the trademarks, that the products at those stores would be of good quality and value; Geoffrey relied on employees at TRUMI to maintain a positive retail environment, including store cleanliness and proper merchandise display; and Geoffrey reviewed licensed products and materials that would be sold in the Commonwealth to ensure high standards and to maintain its positive reputation with Massachusetts consumers, thereby generating continued business and substantial profits. Geoffrey's annual royalty income from retail stores in the Commonwealth for the tax year ending February 1, 1997, was $5,928,567, and it increased to $7,423,420, by the tax year ending February 3, 2001. Based on the findings of the board, we conclude that Geoffrey's activities established a substantial nexus with Massachusetts, and, therefore, the assessment of the corporate excises, pursuant to G. L. c. 63, § 39,

for the tax years at issue comported with the commerce clause.[10]

Geoffrey also contends that the board erred in failing to abate the assessed penalties where the United States Supreme Court's decisions in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*, 386 U.S. 753, 758-760 (1967), and *Quill, supra,* gave Geoffrey reasonable cause to believe that, in the absence of a physical presence in the Commonwealth, it was not subject to Massachusetts corporate excise taxes. At the very least, Geoffrey continues, it should not be penalized for its plausible interpretation of *Quill*, even if such interpretation ultimately proved to be incorrect. In Geoffrey's view, it exercised

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[10] Closely related to the requirement of "substantial nexus" for imposition of an income-based excise on an out-of-State corporation is the requirement that the tax be "fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). In its brief, Geoffrey suggests that, without physical presence, it would be difficult to conclude that the corporate excise taxes assessed here were "fairly related to" actual benefits provided by the Commonwealth. Geoffrey's appeal to the board focused on the substantial nexus prong of the *Complete Auto* test. Consequently, the board did not address whether the corporate excise tax was fairly related to services provided by the Commonwealth. Generally speaking, a corporation engaged in business activities in Massachusetts could be the beneficiary of services provided by the State, even in the absence of physical presence. For example, growth in the retail marketplace may necessitate governmental action to address increased traffic on Massachusetts roads, potentially greater demands on the Commonwealth's labor force, and the necessity for adequate police and fire protection.

ordinary business care and prudence. Further, Geoffrey argues that it should not be penalized for what it characterizes as the commissioner's lack of a clear policy in this area of taxation. See, e.g., *Sherwin-Williams Co. v. Commissioner of Revenue,* 438 Mass. 71, 72-73 (2002) (commissioner challenged intercompany royalty payments for lacking economic substance, but did not attempt to tax out-of-State affiliated licensor).

Pursuant to G. L. c. 62C, § 33, the commissioner shall assess penalties on a taxpayer for failure to file timely returns and failure to pay taxes. General Laws c. 62C, § 33(*f*), provides for an abatement of penalties "[i]f it is shown that any failure to file a return or to pay a tax in a timely manner is due to reasonable cause and not due to willful neglect." Reasonable cause will be established where, at a minimum, a taxpayer has demonstrated that "he exercised the degree of care that an ordinary taxpayer in his position would have exercised." *Commissioner of Revenue v. Wells Yachts S., Inc.,* 406 Mass. 661, 665 (1990).

In 1996, the commissioner issued DD 96-2 (directive), Official MassTax Guide 115-118 (West Supp. 1996), which set forth the commissioner's position as to when the ownership and use of intangible property in the Commonwealth would subject a foreign corporation to corporate excise

taxes.[11] The directive states that "[t]he definition of intangible property generally includes, but is not limited to, copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how." It further provides:

> "A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise when:
>
> "1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise; and
>
> "2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and
>
> "3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimis."

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[11] The purposes of such public written statements "are to inform Department [of Revenue] personnel and the public of Department policy and practice, thereby promoting the uniform application of the Massachusetts tax laws by the Department and assisting taxpayers in complying with the Massachusetts tax laws." 830 Code Mass. Regs. § 62C.3.1(6)(c) (1993). A directive "states the official position of the Department," and it will be used "as precedent in the disposition of cases unless and until it is revoked or modified." *Id.* at § 62C.3.1(6)(d) (1993).

The board acted within its discretion in refusing to abate the penalties levied on Geoffrey. The Supreme Court's decision in *Quill* discussed a "physical-presence" requirement under the commerce clause only in the context of sales and use taxes. See *Quill Corp. v. North Dakota,* 504 U.S. 298, 314, 317 (1992). Prior to the tax years at issue here, the South Carolina Supreme Court in *Geoffrey, Inc. v. South Carolina Tax Comm'n,* 313 S.C. 15, 23-24 (1993), addressed the same constitutional issue as presented in this case with regard to the same taxpayer under a similar factual scenario and concluded that "by licensing intangibles for use in [South Carolina] and deriving income from their use [there], Geoffrey ha[d] a 'substantial nexus' with South Carolina." In addition, the commissioner's issuance of the directive clarified the Commonwealth's tax treatment of income generated by intangible property used within Massachusetts by a foreign corporation. To the extent that Geoffrey was uncertain about its obligation to pay corporate excise taxes or disagreed with the department's position as set forth in the directive, there is no evidence in the record that it sought a letter ruling or other guidance from the department on these matters. See 830 Code Mass. Regs. § 62C.3.2 (1993) (describing purposes of and procedures for letter rulings). See also 830 Code Mass. Regs. § 63.39.1(9) (1993) (setting forth procedures for requesting nexus determination from commissioner). Contrary to Geoffrey's assertion, the issue whether TRUMI was entitled to deduct from its own taxes the royalty payments made to Geoffrey was unrelated to

the issue whether Geoffrey was obligated to pay corporate excises on its Massachusetts income. We conclude that Geoffrey has not demonstrated that it acted with reasonable cause in failing to file corporate excise returns and in failing to pay taxes pursuant to G. L. c. 63, § 39. Therefore, the penalties imposed on Geoffrey by the board were properly assessed.

Decision of the Appellate Tax Board affirmed.

APPENDIX B

Supreme Judicial Court for the
Commonwealth of Massachusetts
John Adams Courthouse
One Pemberton Square, Suite 1400,
Boston, Massachusetts 02108-1724
Telephone 617-557-1020, Fax 617-557-1145

Dated: November 21, 2007

Paul H. Frankel
Morrison & Foerster LLP
1290 Avenue of the Americas
New York, NY 10104

RE: No. DAR-16548

GEOFFREY, INC.
vs.
COMMISSIONER OF REVENUE

Appellate Tax Board No. C271816
A.C. No. 2007-P-1559

NOTICE OF ALLOWANCE OF APPLICATION FOR DIRECT APPELLATE REVIEW

Notice is hereby given that on 11/21/07, the above-captioned Application for Direct Appellate Review was allowed.

Upon receipt of the case papers from the Appeals Court, notice will be sent to counsel indicating the new S.J.C. docket number, the number of briefs/

appendices transferred, and the Sitting to which the case is assigned for argument before the full bench.

Susan Mellen, Clerk

To: Maxwell D. Solet, Esquire
Anne P. Hristov, Esquire
Thomas A. Barnico, A.A.G.
Paul H. Frankel

APPENDIX C

[SEAL]

THE COMMONWEALTH OF MASSACHUSETTS
Appellate Tax Board
100 CAMBRIDGE STREET
SUITE 200
Boston, Massachusetts 02114

(617) 727-3100
(617) 727-6234 Fax

Docket No. C271816

GEOFFREY, INC.,
Appellant.

COMMISSIONER OF REVENUE,
Appellee.

DECISION

The decision is for the appellee. Chairman Hammond took no part in the consideration or decision of this appeal.

APPELLATE TAX BOARD

By: /s/ Frank J. Scharaffa Commissioner
Nancy T. Egan Commissioner
James D. Rose Commissioner
Thomas J. Mulhern Commissioner

Attest: /s/ Michelle Tallent Asst. Clerk

Date: JUL 24 2007
(Seal)

COMMONWEALTH OF MASSACHUSETTS
APPELLATE TAX BOARD

GEOFFREY, INC. **v.** **COMMISSIONER OF REVENUE**

Docket No. C271816

Promulgated:
July 24, 2007

This is an appeal under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39 from the refusal of the appellee Commissioner of Revenue ("appellee" or "Commissioner") to grant an abatement of corporate excises assessed against appellant Geoffrey, Inc. ("Geoffrey") under G.L. c. 63, § 39 for the taxable years ending January 31, 1997 through January 31, 2001.

Commissioner Gorton heard this appeal. With Commissioner Gorton materially participating in the deliberations of this appeal[1] Commissioners Scharaffa, Egan, Rose and Mulhern joined in the decision for the appellee, adopting the

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[1] On September 11, 2006, Commissioner Gorton was sworn as a temporary member of the Appellate Tax Board pursuant to G.L. c. 58A, § 1, his status as a member of the Board having terminated on that date with the appointment and qualification of his successor. *See* G.L. c. 30, § 8. Commissioner Gorton's material participation in the deliberations of these appeals included, *inter alia*, drafting and distributing proposed findings of fact supplying a report on the evidence and his observations as to witness credibility. He also made oral presentations of his recommendations to the Board members.

recommendations of the hearing officer. Chairman Hammond took no part in the consideration or decision of this appeal.

These findings of fact and report are made on the Appellate Tax Board's own motion under G.L. c. 58A, § 13 and 831 CMR 1.32 and are promulgated simultaneously with its decision.

Paul H. Frankel, Esq., *Irwin M. Slomka,* Esq., and *Maxwell D. Solet,* Esq. for the appellants.

Thomas W. Hammond, Esq., *Anne P. Hristov,* Esq., and *Patricia M. Good,* Esq. for the appellee.

FINDINGS OF FACT AND REPORT

Geoffrey challenged the validity of a corporate excise deficiency assessment made by the appellee for the taxable years ending January 31, 1997 through January 31, 2001 inclusive ("years at issue"). Geoffrey's claim rested principally on the Commerce Clause of the United States Constitution (U.S. Const. art. I, § 8, cl. 3 (the "Commerce Clause"). On the basis of the parties' Agreed Statements of Facts and the testimony and exhibits presented at trial, the Board made the following findings of fact, relying on and adopting the recommendations of the hearing officer as to issues of witness credibility.

During the appellee's audit of Geoffrey's affiliated entity, Toys "R" Us-Mass, Inc. ("TRUMI"), the Commissioner discovered that Geoffrey received royalty income from TRUMI for the licensure of

Geoffrey's trademarks, trade names, and service marks for TRUMI's use in its retail business activities in Massachusetts. Taxation of this royalty income, and separate royalty income paid to Geoffrey by Baby Superstore, Inc., which was also licensed to use Geoffrey's intellectual property in Massachusetts, supplied the basis for the assessments at issue.

On October 2, 2002, the Commissioner issued a Notice of Failure to File Return to Geoffrey for the taxable years spanning February 1, 1996 through January 31, 2001. On or about October 15, 2002, Geoffrey supplied to the Audit Division of the Department of Revenue ("DOR") unsigned, pro-forma Massachusetts Foreign Business or Manufacturing Corporation Excise Returns ("Returns") for the years at issue. A Notice of Intention to Assess was issued on December 14, 2002; a revised notice followed on December 23, 2002.

On January 28, 2003, the Commissioner issued a Notice of Assessment to Geoffrey for the years at issue, in the amount of $1,692,568 in corporate excise plus statutory additions.[2] Appellee apportioned Geoffrey's royalty income to Massachusetts based on a sales factor alone, because its property and payroll factors were each less than 3.33% of its taxable net income. The sales factor was computed on the basis of

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[2] The parties' Second Supplemental Stipulation of Facts corrected that the amount of tax in dispute is actually $1,257,793.

the ratio of Geoffrey's royalty income from Massachusetts retail operations, to its royalty and interest income from all sources.

Geoffrey filed an Application for Abatement on February 25, 2003. The Commissioner's Notice of Abatement Determination, denying the requested abatement, was issued on September 19, 2003. Geoffrey filed a Petition Under Formal Procedure with the Appellate Tax Board ("Board"), commencing the instant appeal, on November 18, 2003. The foregoing facts establish the Board's jurisdiction over this appeal.

Geoffrey presented three witnesses at trial: Mr. Peter Weiss, the Senior Vice President for Taxes of Toys "R" Us, Inc., and an officer and director of Geoffrey; Professor Richard D. Pomp of the University of Connecticut Law School; and attorney Paul Fields of the New York law firm of Darby and Darby. Mr. Weiss testified about the business structure of the Toys "R" Us family of corporations. Professor Pomp offered an opinion – based on economic policy considerations – regarding the interpretation of the "substantial nexus" requirement which governs state taxation of businesses engaged in interstate commerce. Mr. Fields, an expert in the field of intellectual property who had served as outside counsel to Geoffrey and other Toys "R" Us entities on trademark and trade name issues, described efforts to protect Geoffrey's interests in its trademarks, trade names, and service marks. The factual testimony, which was credible and uncontradicted, served to

supplement the stipulated facts, and was relied on by the hearing officer and the Board to flesh out the relevant circumstances in a number of details.

The operative facts are undisputed. The corporate parent of both Geoffrey and TRUMI was Toys "R" Us, Inc., which was a publicly held company during the years at issue. It held shares in the various Toys "R" Us operating subsidiaries and provided management and support services to the stores and companies. TRUMI, a first-tier subsidiary of Toys "R" Us, Inc., operated retail toy and children's clothing stores in Massachusetts. During the years at issue, TRUMI operated a total of 26 Toys "R" Us and Kids "R" Us retail stores at locations throughout the Commonwealth. TRUMI filed Massachusetts corporate excise tax returns on a single-entity basis.

TRU, Inc., a holding company, was a subsidiary of Toys "R" Us, Inc. and the parent of Geoffrey. Geoffrey was incorporated in Delaware on January 28, 1984. Effective August 1, 1984, Toys "R" Us, Inc. transferred trademarks, trade names, and service marks (the "Trademarks") to Geoffrey, including the "Toys 'R' Us" and "Kids 'R' Us" trademarks in exchange for stock. The Trademarks acquired by Geoffrey also included the "Geoffrey" giraffe character that is the logo for Toys "R" Us.

Arthur Andersen and Company's Valuation Services Group was engaged in 1991 to ascertain a fair market value royalty rate for the Trademarks owned by Geoffrey. In Arthur Andersen's opinion, the

fair market value of the intellectual property owned by Geoffrey was $1.5 billion. Arthur Andersen deemed 3 per cent of net sales revenue to be the fair market value royalty rate for the use of the Toys "R" Us Trademarks, and 2 per cent of net sales revenue to be the fair market value royalty rate for the use of the Kids "R" Us Trademarks. A subsequent transfer pricing study, including a valuation of a royalty rate for licensure of the Trademarks, was performed by Ernst and Young. The Ernst and Young study supported the Arthur Andersen valuation findings.

Geoffrey's business activities entailed entering into licensing agreements which allowed the various Toys 'R' Us, Inc. operating companies to use the Trademarks in support of their retail operations. These agreements were renegotiated following Arthur Andersen's valuation study. Geoffrey's licensing agreement with TRUMI, entered into on May 3, 1992, permitted the use of the subject Trademarks solely in Massachusetts. Geoffrey had the right to review guides used in the creation of advertisements featuring the Trademarks, customer complaint statistics, and private label product testing reports. Geoffrey also had the right to see product samples.

Pursuant to the licensing agreement, Geoffrey received a royalty of 2 per cent of TRUMI's net sales income at Kids "R" Us stores in Massachusetts for the use of the Kids "R" Us Trademarks, and a royalty of 3 per cent of TRUMI's net sales at Toys "R" Us stores located in Massachusetts for the use of the Toys "R" Us Trademarks. Signing for Geoffrey was Howard

Simon, President of Geoffrey, whose offices were situated in Wilmington, Delaware. Jonathon Friedman, an officer of TRUMI, signed for the licensee. His offices were in New Jersey. The agreement was made subject to the laws of Delaware.[3] Geoffrey had no Massachusetts employees or offices and owned no tangible property, real or personal, in Massachusetts during the years at issue.

Geoffrey also licensed Trademarks for the use of "Babies 'R' Us", a division of Baby Superstore, Inc. Babies "R" Us operated stores in three Massachusetts locations during the years at issue. The licensing agreement involving Babies "R" Us, signed in February of 1997, set a royalty rate of 1 per cent of net sales revenue for the fiscal year 1996, 1.5 per cent of net sales for the fiscal year 1997, and 2 per cent of net sales for all years remaining in the duration of the agreement.

In an example of their use in Massachusetts, physical manifestations of the Trademarks would be held out to the public on signage, store displays, and product packaging at the Massachusetts stores operated by TRUMI. The Trademarks were intended to represent to consumers that goods and services sold by licensees were of a certain level of quality. Geoffrey's rights to its Trademarks were

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[3] For the first four years at issue, appellant was based in Wilmington, Delaware. On January 1, 2000, Geoffrey moved its offices and employees to Paramus, New Jersey.

strengthened by their use, including their use by Toys "R" Us, Kids "R" Us, and Babies "R" Us stores in Massachusetts. Geoffrey had access to the Massachusetts courts, and federal courts located in Massachusetts, to protect its interests in its Trademarks and its entitlement to royalty payments under the licensing agreements.

The licensing agreements gave Geoffrey considerable control over how the Trademarks were put to use in Massachusetts, in the interest of preserving their reputation for quality and value. At § 6.3 of the 1992 TRUMI license agreement, Geoffrey retained the right to review product samples and specifications, signs, labels, tags, packaging material, advertising and sales promotion materials, bills, catalogs, pamphlets or the like, which displayed any Trademark information. At § 7.2, TRUMI agreed to comply with Geoffrey's instructions so as to obviate the possibility that the Trademarks might become generic terms, which might adversely affect Geoffrey's interests in its Trademarks.[4]

Pursuant to a Quality Control, Legal And Treasury Service Agreement dated February 6, 1996, Toys "R" Us, Inc. provided services to Geoffrey to assist with quality control issues related to the Trademarks. Toys "R" Us, Inc. dedicated the services of an intellectual property specialist, Ms. Ellen

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[4] Similar provisions appear in Geoffrey's 1997 license agreement with Baby Superstore, Inc.

Storch, to the task of protecting Geoffrey's assets. Toys "R" Us, Inc. also employed the regional and district managers with responsibilities for Massachusetts stores, who could monitor use of the Trademarks in Massachusetts and would bring any problems in stores, *e.g.* issues related to cleanliness, to the attention of the appropriate officials. Toys "R" Us, Inc. produced reports, explaining the results of its quality control activities, and copies were also supplied to Geoffrey. For its services Toys "R" Us, Inc. was paid $300,000 a year.[5]

On January 1, 2000, Geoffrey changed its principal place of business from Wilmington, Delaware to Paramus, New Jersey. Moreover, Toys "R" Us, Inc. entered into a Management Service Agreement with Geoffrey, and certain Toys "R" Us, Inc. employees became employees of Geoffrey, also on January 1, 2000. Toys "R" Us, Inc. continued to make Ms. Starch's services available under the Management Service Agreement to protect Geoffrey's interest in its Trademarks.

Geoffrey entered into an Accounting and Management Services Agreement with Simon, Master, and Sidlow, a Delaware accounting firm, on January 8, 1993. Geoffrey also obtained additional services from several outside firms, including Mr. Fields' law firm, which provided legal services to

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[5] Mr. Weiss attended to quality control issues on behalf of Geoffrey.

Geoffrey to protect its ownership interests and the value of the Trademarks. The Trademarks were registered with the United States Patent and Trademark Office. The Darby law firm, acting on information from Geoffrey and third parties, kept vigilance against any infringements on the Trademarks owned by Geoffrey. Legal services included preparation of "cease and desist" letters to potential infringers. Trademark infringement claims might have led to settlement agreements or litigation by Geoffrey.

The testimony established that Geoffrey acted to protect its Trademarks against claimed infringement by a Massachusetts-based business, "GunsAreUs.com." The claim led to an infringement action in the Federal District Court for the Southern District of New York. The claimed infringer eventually changed its name.

Geoffrey received the following amounts of royalty income with respect to retail stores located in Massachusetts:

Taxable Year Ending:	Royalty Income Received
2/1/97	$5,928,567
1/31/98	$6,554,625
1/30/99	$6,628,656
1/29/00	$7,117,981
2/3/01	$7,423,420

On the basis of the foregoing, the Board found and ruled that Geoffrey's business activities gave it "substantial nexus" with Massachusetts. In reaching this conclusion, the Board agreed that Geoffrey neither owned nor leased real property in Massachusetts. Moreover, the Board found that no employee of Geoffrey was situated in Massachusetts during the years at issue. Nevertheless, Geoffrey purposefully sought to reap economic benefits from the Massachusetts retail marketplace by licensing its assets for use in Massachusetts by TRUMI and Baby Superstore, Inc. The Trademarks were used extensively by Toys "R" Us, Kids "R" Us, and Babies "R" Us stores in Massachusetts. The receipt of substantial royalty income over the course of the years at issue represented the realization of the desired economic benefits from Massachusetts.

Moreover, Geoffrey reserved the ability to regulate the use of its Trademarks in Massachusetts, having rights of approval over promotional activities, product standards, and store conditions which might damage the value of the Trademarks. Finally, Massachusetts afforded rights and protections to Geoffrey in connection with the use of the Trademarks here, including recourse to the courts of the Commonwealth to address issues of trademark infringement and compliance with the terms of the licensing agreements. These facts supported a finding of "substantial nexus," so as to validate the disputed tax assessment.

Accordingly, for all of the foregoing reasons, the Board issued a decision for the appellee in this appeal.[6]

OPINION

The principal issue on this appeal was whether the Commerce Clause requires that a foreign corporation have a "physical presence" in a state in order to support the imposition of that state's income-based corporate excise[7]. Geoffrey also challenged the application of the statutory apportionment formula of G.L. c. 63, § 38 on the ground that it resulted in taxation of extraterritorial values.

The Board first addressed the relevant statutory scheme and Geoffrey's statutory arguments. The assessment arose by operation of G.L. c. 63, § 39, which provides that "every foreign corporation, exercising its charter, or qualified to do business or

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[6] The hearing officer's participation in the deliberations and decision of this case, which included the preparation of recommended findings of fact and rulings of law and consultations with Board members, satisfied the requirements of ***Bayer v. Commissioner of Revenue***, 436 Mass. 302 (2002), as interpreted in the Board's decision in ***Mayflower Emerald Square, LLC v. Board of Assessors of the Town of North Attleborough***, ATB Findings of Fact and Report 2007-421, 517-18.

[7] The tax imposed under G.L. c. 63 is measured on the basis of net income and corporate net worth. *See* G.L. c. 63, § 39(a).

actually doing business in the commonwealth, or owning or using any part or all its capital, plant or any other property in commonwealth, shall pay, on account of each taxable year, the excise provided in subsection (a) or (b) of this section. . . ." The legislative intent of this section is amplified at G.L. c. 63, § 39(3), where it is stated that

> It is the purpose of this section to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges, and immunities derived by reason of the corporate form of existence and operation.

The Appeals Court explained the statutory apportionment methodology in its opinion in ***Dana Lease Finance Corp. v. Commissioner of Revenue,*** 53 Mass. App. Ct. 840, 841 n.1 (2002):

> For corporations having income from business which is taxable both here and another [sic] States, income is apportioned to Massachusetts by multiplying taxable net income by a fraction called the "income apportionment percentage", *see* G.L. c. 63, §§ 30(9), 38(c). This uses the sum of three factors, "property," "payroll," and "sales" in the numerator; if a factor is "insignificant," G.L. c. 63 § 38(g), it is eliminated and the denominator of the fraction is reduced. . . .

Accordingly, given that Geoffrey had no property and payroll in the commonwealth, these two apportionment factors were inapplicable in the relevant calculation, and Geoffrey's net income was apportioned on the basis of a sales factor-derived percentage. *See* G.L. c. 63 § 38(g).[8]

Geoffrey contested the tax with the argument that it made no sales in Massachusetts, and, given its lack of physical presence, its income-producing activities occurred out-of-state. The statute provides that

> Sales other than sales of tangible personal property, are in this commonwealth, if 1. the income-producing activity is performed in this commonwealth; or 2. the income-producing activity is performed both in and outside this commonwealth and a greater proportion of this income-producing activity is performed in this commonwealth than in any other state, based on costs of performance.

G.L. c. 63, § 38(f)[9].

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[8] According to the Audit Narrative, offered jointly by the parties as a stipulated exhibit, DOR simply accepted the numbers for the property and payroll factors that were reflected in Geoffrey's pro forma returns.

[9] The record does not indicate that Geoffrey's royalties from Baby Superstore, Inc. were greater in "any other one state" than in Massachusetts. *See* ***Interface Group-Nevada, Inc. v. Commissioner of Revenue***, ATB Findings of Fact and Report 2000-324, 359-60.

830 CMR 63.38.1(9(d)(3)(c) addresses the sourcing of gross receipts from the licensing of intangible property, like Geoffrey's Trademarks:

> Gross receipts from the licensing of intangible property are attributable to Massachusetts if the property is used by the . . . licensee solely in Massachusetts. If the . . . licensee uses the intangible property in more than one state, the gross receipts from licensing . . . are attributable to Massachusetts if the use of property by the . . . licensee in Massachusetts exceeds its use of the property in any other one state.

The statute, interpreted in light of this regulation, would place the income-producing activity giving rise to the royalty income at issue in Massachusetts on the instant record. TRUMI, the licensee, used Geoffrey's trademarks exclusively in Massachusetts. TRUMI incurred an obligation to pay Geoffrey royalties in agreed percentages based on sales occurring in TRUMI's Massachusetts retail stores. Because Geoffrey's income arose in connection with Massachusetts sales made on the strength of its Trademarks, the relevant income-producing activity was treated as taking place in the commonwealth.

Nevertheless, Geoffrey challenged the rule of 830 CMR 63.38.1(9(d)(3)(c) as being inconsistent with statute, arguing that the statute looked only to *Geoffrey's* activities, none of which formally transpired in Massachusetts. However, "[r]egulations issued by an agency are presumptively valid so long

as they are authorized by the enabling statute and do not violate any other statute or the Federal or State constitution." ***Cohen v. Bd. of Water Commissioners, Fire Dist. No. 1, South Hadley,*** 411 Mass. 744, 749 (1992). As the Supreme Judicial Court has held, "review of the validity of a regulation promulgated by a State agency is guided by the established principle that '[r]egulations are not to be declared void unless their provisions cannot by any reasonable construction be interpreted in harmony with the legislative mandate.'" ***Smith v. Commissioner of Transitional Assistance,*** 431 Mass. 638, 646 (2000) (Citations omitted.)

Geoffrey failed to establish inconsistency between regulation and statute. *Cf.* ***Duarte v. Commissioner of Revenue,*** ATB Findings of Fact and Report 2006-490, 515-16. Nothing in G.L. c. 63, § 38(f) requires so blinkered a view of the relevant income-producing activity as to disregard the important uses to which Geoffrey's Trademarks were put in Massachusetts. In ***Allied Building Credits, Inc. v. State Tax Commission,*** 344 Mass. 503, 507 (1962), the Supreme Judicial Court held that G.L. c. 63 "did not in terms restrict the meaning of assets 'employed in any business within the commonwealth' to assets physically or legally situated here." (Citation omitted.) The taxpayer in ***Allied Building*** bought installment notes made to sellers of lumber, carpets, furniture, and heating and plumbing supplies by the buyers of these products. Though the taxpayer argued that its intangible assets should be

sourced to its state of domicile, California, the Court held that the intangibles were appropriately considered in arriving at the amount of corporate excise payable to the Commonwealth. *Id.* The Court explained that "[l]egal situs of intangibles is, to a degree at least, determinable in light of the purpose of the determination." *Id.* at 508. The Court concluded that "[a] State, in imposing excises, may look to property beyond its borders to get the true value of things within it." ***Id.***

With a profit-seeking intent, Geoffrey licensed its intangibles for use in this state, and earned a share of the proceeds as sales were made at TRUMI's and Baby Superstore's Massachusetts retail locations. The licensing agreements recognized that the value of Geoffrey's Trademarks contributed to retail sale transactions at Toys "R" Us, Kids "R" Us, and Babies "R" Us stores in Massachusetts. "The findings show that in such a business as [Geoffrey's] the out-of-State intangibles may have very important uses within the Commonwealth." *Cf.* ***id.*** Given the intended use of its property to facilitate retail sales in Massachusetts, Geoffrey's assertion that its income-producing activity occurred entirely out-of-state is strained and formalistic.

Furthermore, the Supreme Judicial Court upheld the application of 830 CMR 63.38.1(9[)](d)(3)(c) in ***Boston Professional Hockey Ass'n, Inc. v. Commissioner of Revenue,*** 443 Mass. 276, 282-283, 296-98 (2005). Geoffrey failed to persuade that physical presence or the formal situs of intangible

assets in Massachusetts was a prerequisite to finding income-producing activity within the meaning of the corporate excise statute.[10]

Finally, Geoffrey failed to establish it was entitled to use an alternative method of apportionment, *e.g.* by including a property factor in the apportionment formula used to arrive at the percentage of net income which was attributable to Massachusetts. Geoffrey cited G.L. c. 63, § 42 in arguing that apportionment pursuant to G.L. c. 63, § 38 was "not reasonably adapted to approximate the net income derived from business carried on within this commonwealth. . . ."[11] Yet, beyond bare assertions that its income-producing activities occurred out-of-state, Geoffrey failed to satisfy its burden of showing "by 'clear and cogent evidence' that the income attributed to the Commonwealth is in fact 'out of all appropriate proportion to the business transacted' here or has 'led to a grossly distorted result.'" ***Gillette Co. v. Commissioner of Revenue***,

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[10] Geoffrey also argued that passage of Stat. 2004, c. 262, § 42, which made explicit that use of an intangible asset in Massachusetts qualifies as "income producing activity" for purposes of G.L. c. 63, § 38(f), indicates that the law was otherwise for the years at issue. The Board agreed with the contemporaneous view of TIR 04-22 IV. that "the amendment restates and clarifies existing law in manner consistent with the Commissioner's prior interpretation and practice." *Citing* 830 CMR 63.38.1(9(d)(3)(c).

[11] There is no indication on the record that Geoffrey actually applied to the Commissioner utilizing the G.L. c. 63, § 42 procedure.

425 Mass. 670, 679 (1997) (Citations omitted.) "[B]lanket assertions" of the sort Geoffrey relied on are not sufficient to warrant application of G.L. c. 63, § 42. *See* ***id.***

Geoffrey's constitutional claim relied on a broad reading of the decision of the United States Supreme Court in ***Quill Corp. v. North Dakota,*** 504 U.S. 298, 305 (1992), to argue that the Commerce Clause precluded application of the corporate excise given its lack of physical presence in Massachusetts. ***Quill*** reaffirmed the prior decision of the Court in ***National Bellas Hess, Inc. v. Department of Revenue of Illinois,*** 386 U.S. 753 (1967), which held that a taxpayer's physical presence in a state was necessary to square that state's imposition of a sales or use tax with the Commerce Clause. While this constitutional question may have been open at the time of trial, it has since been resolved by the Board. In ***Capitol One Bank and Capitol One F.S.B. v. Commissioner of Revenue,*** ATB Findings of Fact and Report 2007-544, 565, the Board held that "neither . . . Supreme Court nor Massachusetts precedent supports the proposition that physical presence is required to impose an income-based tax. . . ." Indeed, as ***Capitol One*** emphasizes, "Massachusetts has recognized the Supreme Court's careful limitation of ***Quill*** to the sales and use tax context." ***Id.*** at 2007-565.

Capitol One settled that the authority governing Geoffrey's Commerce Clause claim is ***Complete Auto Transit, Inc. v. Brady,*** 430 U.S.

274, 279 (1977), which authorized state taxation of "a company engaged in purely interstate commerce provided that the tax: '[1] is applied to an activity with a substantial nexus with the taxing state, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, [4] and is fairly related to the services provided by the State.'" ATB Findings of Fact and Report 2007-560. Focusing on the first prong of the ***Complete Auto Transit*** test, which is the crux of Geoffrey's claim, the Board observed that "'[s]ubstantial nexus' comprises contacts of varied character and not merely those of a physical nature." ***Id.*** at 566. The Board agreed with the Supreme Court of Appeals of West Virginia, which held that "[r]ather than a physical presence standard, this Court believes that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes." ***Tax Commissioner of West Virginia v. MBNA America Bank, N.A.,*** 640 S.E.2d 226, 234 (2006). "[T]he [West Virginia] court, despite finding that the taxpayer had no real or tangible personal property or real estate located in the state, had 'no trouble concluding that MBNA's systematic and continuous business activity in this State produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of ***Complete Auto***.'" ATB Findings of Fact and Report at 2007-567, *quoting* 640 S.E.2d at 236.

Capitol One also relied on other cases in which a company was deemed subject to an income-based tax based "solely on the presence of [intangible] trademark assets within the taxing jurisdiction." ATB Findings of Fact and Report 2007-569, *citing, e.g.*, ***Geoffrey, Inc. v. South Carolina Tax Commission,*** 437 S.E.2d 13 (S.C. 1993). In a case involving a similar claim by the same taxpayer, the South Carolina Supreme Court held that "by licensing intangibles for use in this state and deriving income from their use here, Geoffrey ha[d] a 'substantial nexus' with South Carolina." ***Geoffrey,*** 437 S.E.2d at 18. In ***Lanco, Inc. v. Director, Division of Taxation,*** 879 A.2d 1234, 1235 (N.J. Super. Ct. App. Div. 2005), *aff'd*, 908 A.2d 176 (N.J. 2006), the Appellate Division of the New Jersey Superior Court upheld an income-based tax on a foreign trademark holding company with "no physical presence in the state [which] derive[d] income from a New Jersey source pursuant only to a license agreement with another corporation that conducts a retail business" in the state. In affirming the Appellate Division, the New Jersey Supreme Court held that "[i] **Quill**, the court did not attempt to equate the substantial-nexus requirement with a universal physical-presence requirement." 908 A.2d at 177. *See also* ***Secretary, Department of Revenue v. Gap (Apparel), Inc.,*** 886 S.2d 459, 462 (La. Ct. App. 2004) ("While Apparel may not have a physical presence in Louisiana, its intangible property clearly has a connection with Louisiana . . . [and] it is clear that the marks licensed by Apparel have been used in Louisiana in such a way as to become an integral part

of the licensees' business in this state.") *Accord* ***Kmart Properties, Inc. v. Taxation and Revenue Department,*** 139 N.M. 177, 185 (N.M. Ct. App 2001); ***A&F Trademark, Inc. v. Tolson,*** 605 S.E.2d 187, 195 (N.C. Ct. App. 2004).

The Board held in ***Capitol One*** "consistent with the overwhelming weight of authority from the Supreme Court and those jurisdictions that have addressed the question, that the physical presence requirement in ***Quill*** is not applicable to an income based excise. . . ." ATB Findings of Fact and Report at 2007-572-573. Instead, as the Board observed, "the use of Capitol One's intangible property – the Capitol One trademark on the cards – within the Massachusetts economic market to generate substantial revenue further supports the Board's ruling that there was substantial nexus."[12]

As in ***Capitol One,*** Geoffrey here purposefully "derived substantial economic gain from the

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[12] The use of an "economic presence" criterion to apply the "substantial nexus" requirement also accords with the "well established" rule in the field of taxation "'that the substance should prevail over form.'" *See generally* ***Spirit of Yankee, Inc. v. Commissioner of Revenue,*** ATB Findings of Fact and Report 1998-723, 733 (Citations omitted.) Although intangibles definitionally lack a physical situs, the effective presence of the Trademarks in Massachusetts is substantiated every day by Massachusetts consumers' purchase decisions in reliance on the assurances of product quality and value represented by the name "Toys 'R' Us." *Cf.* ***Allied Building Credits,*** 344 Mass. at 507-08.

Massachusetts market through a sophisticated marketing campaign" that harnessed the value of its intangibles to induce Massachusetts customers to make purchases from which it profited. *Cf.* ATB Findings of Fact and Report at 2007-573. The good will represented by Geoffrey's Trademarks, which was carefully guarded, and the assurance of product quality they were intended to give, enabled transactions to occur in Massachusetts from which Geoffrey obtained substantial royalty income.[13] The Board found compelling the fact that Geoffrey derived over $33 million in royalties from the Massachusetts consumer marketplace during the years at issue, in ruling that the "substantial nexus" prong of ***Complete Auto Transit*** was satisfied by its economic presence in Massachusetts.

Geoffrey's final argument seeks abatement of penalties for underpayment of tax and late filing, pursuant to G.L. c. 62C, § 33(a). It contends that justifiable reliance on the ***Quill*** decision supplied reasonable cause for its decision not to file Massachusetts tax returns or pay Massachusetts corporate excise, given its lack of physical presence.

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[13] As in ***Capitol One,*** the Board found that Geoffrey's expert witness's "opinions from an economic and policy perspective" to be unpersuasive in resolving the statutory and constitutional questions presented. ATB Findings of Fact and Report at 2007-574. The Board's task is to adhere to the policy choices made by the legislature and follow the precedents set by the courts.

However, ***Quill*** addresses sales and use taxation, not an income-based corporate excise, a fact the Supreme Judicial Court stressed in ***Truck Renting and Leasing Assn v. Commissioner of Revenue,*** 433 Mass. 733, 740 n.13 (2001) ("In ***Quill*** the Court upheld a 'physical-presence requirement' before a State, consistent with the commerce clause, could subject an out-of-State vendor to a use or sales tax. *The Court did not extend this rule to other types of tax.*") (Emphasis added.) Geoffrey's efforts to have the rule of ***Quill*** extended beyond the sales and use tax context did not justify its failure to comply with the taxing laws of the Commonwealth, which are entitled to a presumption of constitutionality. *See, e.g.*, ***Kienzler v. Dalkon Shield Claimants Trust,*** 426 Mass. 87, 89 (1997). "Reasonable cause . . . 'should not be read to include a clearly erroneous view of the law, stubbornly adhered to after investigation should have disclosed the error.'" ***United States v. Bell Credit Union,*** 860 F.2d 365, 372 (10th Cir. 1988), *quoting* ***United States v. Sterling Nat'l Bank & Trust. Co.,*** 494 F.2d 919, 925 (2nd Cir. 1974) (Friendly, J., dissenting).

In conclusion, the Board found that the disputed assessment was authorized by the corporate excise statute, and did not transgress the constitutional limits on the exercise of a state's taxing power. Moreover, Geoffrey did not demonstrate that it acted with reasonable cause in its failure to file returns or

pay taxes. The Board decided this appeal for the appellee.

THE APPELLATE TAX BOARD

By: /s/ Frank J. Scharaffa
Frank J. Scharaffa,
Commissioner

A true copy,

Attest: /s/ Michelle Tallent
Assistant Clerk of the Board

APPENDIX D

GENERAL LAWS OF THE COMMONWEALTH OF MASSACHUSETTS, 1932, CHAPTER 63 TAXATION OF CORPORATIONS, Domestic Corporations.

Sec. 38. Allocation of net income.

The commissioner shall determine the part of the net income of a domestic business corporation or of a foreign corporation derived from business carried on within the commonwealth as follows:

(a)

Net income as defined in section thirty of this chapter adjusted as follows shall constitute taxable net income:

(1)

Ninety-five per cent of dividends, exclusive of distributions in liquidation, included therein shall be deducted other than dividends from or on account of the ownership of:

(i)

shares in a corporate trust, as defined in section one of chapter sixty-two, engaged in business in the commonwealth, or

(ii)

deemed distributions and actual distributions, except actual distributions out of previously taxed income, from a DISC which is not a wholly-owned DISC, or

(iii)

any class of stock, if the corporation owns less than fifteen percent of the voting stock of the corporation paying such dividend.

(2)

Long-term capital gains realized and long-term capital losses sustained from the sale or exchange of intangible property affected under the provisions of the Federal Internal Revenue Code, as amended and in effect for taxable years ended on or before December thirty-first, nineteen hundred and sixty-two, shall not be included in any part therein.

(b)

If the corporation does not have income from business activity which is taxable in another state, the whole of its taxable net income, determined under the provisions of subsection *(a)*, shall be allocated to this commonwealth. For purposes of this section, a corporation is taxable in another state if (1) in that state such corporation is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject such corporation to a net income tax regardless of whether, in fact, the state does or does not.

* * *

(c)

If a corporation, other than a defense corporation as described in subsection *(k)*, a manufacturing corporation as described in subsection *(l)*, or a mutual fund service corporation to the extent of its mutual fund sales as described in subsection *(m)*, has income from business activity which is taxable both within and without this commonwealth, its taxable net income, as determined under the provisions of subsection *(a)*, shall be apportioned to this commonwealth by multiplying said taxable net income by a fraction, the numerator of which is the property factor plus the payroll factor plus twice times the sales factor, and the denominator of which is four.

(d)

The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in this commonwealth during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year. Property owned by the corporation shall be valued at its original cost. Property rented by the corporation shall be valued at eight times the net annual rental rate, provided such rate reflects the fair rental value of the property as of the date of the rental agreement. Net

annual rental rate is the annual rental rate paid by the corporation less any annual rental rate received by the corporation from sub-rentals.

The average value of property shall be determined by averaging the values at the beginning and the end of the taxable year, but the commissioner may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the corporation's property. For the purpose of this subsection leaseholds and leasehold improvements, whether located within or without the commonwealth, shall be included within the meaning of real and tangible personal property.

(e)

The payroll factor is a fraction, the numerator of which is the total amount paid in this commonwealth during the taxable year by the corporation for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year.

The payroll factor for a manufacturing corporation or a business corporation engaged primarily in research and development, which has been deemed to be such under the provisions of section thirty-eight C or forty-two B, is a fraction the numerator of which is the lesser of the following amounts: –

(i)

the total amount paid in this commonwealth by the corporation for compensation during the taxable year; or

(ii)

the greater of (a) the total amount paid in this commonwealth by the corporation for compensation during the taxable year ended in the year nineteen hundred and seventy-two increased by five per cent per year for each taxable year subsequent to the taxable year ended in nineteen hundred and seventy-two; or (b)

(1) in taxable years ending on or after December thirty-first, nineteen hundred and eighty-two and before December thirty-first, nineteen hundred and eighty-three, seventy-five per cent of the total amount paid in this commonwealth by the corporation for compensation, (2) in taxable year ending on or after December thirty-first, nineteen hundred and eighty-three and before December thirty-first, nineteen hundred and eighty-four, eighty per cent of the total amount paid in this commonwealth by the corporation for compensation, (3) in taxable year ending on or after December thirty-first, nineteen hundred and eighty-four, and before December thirty-first, nineteen hundred and eighty-five, ninety per cent of the total amount paid in this commonwealth by the corporation for compensation, and (4) in taxable years ending on or after December

thirty-first, nineteen hundred and eighty-five and thereafter, the total amount paid in this commonwealth by the corporation for compensation.

The denominator of the payroll factor for such corporation shall be adjusted for compensation paid in this commonwealth to include in total compensation paid everywhere only that amount for compensation paid in this commonwealth which is equal to the amount included in the numerator as determined under *(i)* and *(ii)* in this subsection.

Notwithstanding the provisions of this subsection, a corporation shall be eligible for the credit provided for in section thirty-one C. For the purposes of determination of the credit under section thirty-one C, the total amount of compensation paid in this commonwealth by the corporation for the taxable year shall be allowed.

As used in this subsection, "compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Compensation is paid in this commonwealth if:

1.

the employee's service is performed entirely within this commonwealth; or

2.

the employee's service is performed both within and without this commonwealth, but the service performed without this commonwealth is incidental to the employee's service within this commonwealth; or

3.

some of the service is performed in this commonwealth and (i) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this commonwealth, or (ii) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the employee's residence is in this commonwealth.

* * *

(f)

The sales factor is a fraction, the numerator of which is the total sales of the corporation in this commonwealth during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. As used in this subsection, "sales" means all gross receipts of the corporation except interest, dividends, and gross receipts from the maturity, redemption, sale, exchange or other disposition of securities. Sales of tangible

personal property are in this commonwealth if:

1.

the property is delivered or shipped to a purchaser, including the United States government, within this commonwealth regardless of the f. o. b. point or other conditions of the sale; or

2.

the corporation is not taxable in the state of the purchaser and the property was not sold by an agent or agencies chiefly situated at, connected with or sent out from premises for the transaction of business owned or rented by the corporation outside this commonwealth. "Purchaser", as used in clauses 1 and 2 of this paragraph, shall include the United States government.

Sales, other than sales of tangible personal property, are in this commonwealth if:

1.

the income-producing activity is performed in this commonwealth; or

2.

the income-producing activity is performed both in and outside this commonwealth and a greater portion of this income-producing activity is performed in this commonwealth than in any other state, based on costs of performance.

For the purposes of this subsection the corporation will be deemed to be taxable in the state of the purchaser if the tangible personal property is delivered or shipped to a purchaser in a foreign country; sales of tangible personal property to the United States government or any agency or instrumentality thereof for purposes of resale to a foreign government or any agency or instrumentality thereof are not sales made in this commonwealth; and sales by a corporation to its wholly owned DISC shall be treated as though made directly by such corporation to the customer of such DISC.

Notwithstanding the foregoing, mutual fund sales by a mutual fund service corporation as defined in subsection *(m)*, other than the sale of tangible personal property, shall be assigned to this commonwealth to the extent that shareholders of the regulated investment company are domiciled in this commonwealth as follows:

(a)

by multiplying the mutual fund service corporation's total dollar amount of sales of such services on behalf of each regulated investment company by a fraction, the numerator of which shall be the average of the number of shares owned by the regulated investment company's shareholders domiciled in this commonwealth at the beginning of and at the end of the regulated investment company's taxable year that ends

with or within the mutual fund service corporation's taxable year, and the denominator of which shall be the average of the number of shares owned by the regulated investment company shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year that ends with or within the mutual fund service corporation's taxable year.

(b)

A separate computation shall be made to determine the sale for each regulated investment company, the sum of which shall equal the total sales assigned to the commonwealth.

The commissioner shall promulgate regulations to implement the provisions of this paragraph.

(g)

In a case where only two of the foregoing three factors are applicable, the taxable net income of the corporation shall be apportioned by a fraction, the numerator of which is the remaining two factors with their respective weights and the denominator of which is the number of times that such factors are used in the numerator. If only one of the three factors is applicable, the taxable net income of the corporation shall be apportioned solely by that factor. A factor shall not be deemed to be inapplicable merely because the numerator of the factor is

zero. A factor shall not be applicable if the denominator of the factor is less than ten per cent of one third of the taxable net income or if it is otherwise determined to be insignificant in producing income.

(h)

If a corporation maintains an office, warehouse or other place of business in a state other than this commonwealth for the purpose of reducing its tax under this chapter, the commissioner shall, in determining the amount of taxable net income apportionable to this commonwealth, adjust any factor to properly reflect the amount which the factor ought reasonably to assign to this commonwealth.

(i)

In the case of consolidated returns of net income, the commissioner shall apportion the taxable net income, so far as practicable, in accordance with apportionment rules set forth in this section.

(j)

If the apportionment provisions of this section are not reasonably adapted to approximate the net income derived from business carried on within this commonwealth by any type of industry group, the commissioner may, by regulation, adopt alternative apportionment provisions

to be applied to such an industry group in lieu of the foregoing provisions.

(k) (1)

As used in this section, the following words shall, unless the context otherwise requires, have the following meaning:

"Base period property level", the average value of all the corporation's real and tangible personal property, owned or rented, and used in this commonwealth, as computed under subsection (d), for the corporation's taxable year immediately preceding its first taxable year, on or after January first, nineteen hundred and ninety-six, as adjusted to include only real and tangible personal property actively used by the corporation in the conduct of a trade or business on the first day of the immediately succeeding taxable year.

"Base period payroll level", the total amount paid in this commonwealth for compensation, as computed under subsection (e), excluding amounts paid or attributable to the ten most highly compensated officers, or employees, for the corporation's taxable year immediately preceding its first taxable year beginning on or after January First, nineteen hundred ninety-six, as adjusted to include only compensation paid during such taxable year to individuals who are actively employed by the corporation on the first day of the immediately succeeding taxable year.

"Defense corporation", a domestic or foreign corporation which, during the sixty month period ending on December thirty-first, nineteen hundred and ninety-five, has derived more than fifty percent of its total gross receipts from the manufacture of tangible personal property for sale directly or, in the case of a subcontractor, indirectly, to the Department of Defense or any branch of the Armed Forces of the United States.

"Property level", the average value of all the corporation's real and tangible personal property owned or rented and used in this commonwealth for the corporation's taxable year, as computed under subsection (d).

"Payroll level", the total amount paid in this commonwealth for compensation for the corporation's taxable year, as computed under subsection (e), excluding amounts paid or attributable to the ten most highly compensated officers or employees.

(2)

For any taxable year beginning on or after January first, nineteen hundred and ninety-six but before January first, two thousand, a domestic or foreign defense corporation may, if required to apportion its taxable net income pursuant to subsection (1), elect to have such apportionment determined solely by use of the sales factor. A defense corporation must apportion its income pursuant to said subsection (1) if the denominator of the sales factor is less than

ten percent of the taxable net income or is otherwise determined to be insignificant in producing income. A defense corporation's ability to apportion its taxable net income solely by use of the sales factor shall be reduced to the extent set forth in paragraph (3).

(3)

If for any taxable year beginning on or after January first, nineteen hundred and ninety-six but before January first, two thousand, such corporation's property level is less than ninety percent of the base period property level or its payroll level is less than ninety percent of the base period payroll level, the corporation shall instead be required to apportion its taxable net income for such taxable year to the commonwealth in accordance with subsection (1); provided, however, that any reduction in the property level or payroll level for any taxable year that is demonstrated to be attributable to a net reduction in business in this commonwealth under contracts with any branch of the Armed Forces of the United States or with any military or defense agency of a foreign government not resulting from transfers of contract work to facilities of the corporation in other states shall not be taken into account in determining whether the property or payroll level for such taxable year is less than ninety percent of the comparable base period level.

(4)

The commissioner of revenue shall promulgate rules and regulations implementing the provisions of this subsection.

(5)

For the purposes of determining compliance with the provisions of paragraphs (2), (3) and (4), each defense corporation with more than twenty-five employees, as part of its tax return for each taxable year, shall submit a report, whose form and substance shall be determined by the commissioner of revenue, that describes for each taxable year as of the last day of such taxable year the following:

(i)

the number, nature and wages of jobs added or lost in the commonwealth and worldwide from the previous taxable year;

(ii)

the number of contracts with the Armed Forces of the United States or a foreign government for which a bid was (a) submitted, (b) awarded or (c) lost during the taxable year;

(iii)

the number of contracts with the Armed Forces of the United States or with foreign

governments that were terminated during the taxable year;

(iv)

the nature and amount of any change in the property factor during the taxable year;

(v)

the nature and amount of any change in the payroll factor in the taxable year;

(vi)

the dollar amount of revenue foregone by the adoption and utilization of the single sales actor pursuant to this section as compared to the apportionment method in effect for the first taxable year beginning on or after January first, nineteen hundred and ninety-five;

(vii)

volume of sales in the commonwealth and worldwide;

(viii)

taxable income in the commonwealth and worldwide;

(ix)

book value of plant, land and equipment in the commonwealth and worldwide;

(x)

net capital investment in the commonwealth and worldwide;

(xi)

net assets;

(xii)

capacity utilization; and

(xiii)

debts, itemized by the following categories:

(a)

loans; and

(b)

mortgages.

The commissioner of revenue shall annually prepare a comprehensive report utilizing the information received in this paragraph and other sources describing and evaluating the impact, if any, of the utilization of the single sales factor only upon the defense industry. Said report shall contain only cumulative information for all defense corporations submitting reports. Said report shall set forth for all defense corporations submitting reports the cumulative totals worldwide and, where applicable, in the commonwealth of the items specified in clauses (i) to (xiii) and the changes in such aggregate totals from the previous taxable year. The

commissioner's report shall be filed not later than October first of each year with the clerk of the senate and the clerk of the house of representatives who shall forward the same to their respective committees on ways and means and to the joint committee on taxation. Said report of the commissioner shall be a public record.

(l) (1)

As used in this section, the following words shall, unless the context otherwise requires, have the following meaning:

"Manufacturing corporation", a domestic or foreign corporation that is engaged in manufacturing. In order to be engaged in manufacturing, the corporation must be engaged, in substantial part, in transforming raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature and adapted to a new use.

A domestic or foreign manufacturing corporation's activities will be considered to be substantial if any one of the following five tests are met:

1.

twenty-five percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;

2.

twenty-five percent or more of its payroll is paid to employees working in its manufacturing operations and fifteen percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;

3.

twenty-five percent or more of its tangible property is used in its manufacturing operations and fifteen percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;

4.

thirty-five percent or more of its tangible property is used in its manufacturing operations; or

5.

the corporation's manufacturing activities are deemed substantial under relevant regulations promulgated by the commissioner.

In determining whether a process constitutes; manufacturing, the commissioner will examine the facts and circumstances of each case.

For the purposes of this section, a corporation which apportions its income pursuant to subsection (k) is not a manufacturing corporation.

(2)

if a manufacturing corporation, as defined paragraph (1), has income from business activity which is taxable both within and without this commonwealth, its taxable net income, determined under, the provisions of subsection (a), shall not be apportioned pursuant to the percentage that results from the three-factor formula set forth in subsection (c) but, instead, shall be apportioned by multiplying its taxable net income, determined under the provisions of subsection (a), by the resulting percentage as determined in the following formulas:

(i)

For taxable years beginning on or after January first, nineteen hundred and ninety-six but before January first, nineteen hundred and ninety-seven, twenty percent of the property factor plus twenty percent of the payroll factor plus sixty percent of the sales factor.

(ii)

For taxable years beginning on or after January first, nineteen hundred and ninety-seven but before January first, nineteen hundred and ninety-eight, fifteen percent of the property factor plus fifteen percent of the payroll factor plus seventy percent of the sales floor.

(iii)

For taxable years beginning on or after first, nineteen hundred and ninety-eight but before January first, nineteen hundred and ninety-nine, ten percent of the property factor plus ten percent of the payroll factor plus eighty percent of the sales factor.

(iv)

For taxable years beginning on or after January first, nineteen hundred and ninety-nine but before January first, two thousand, five percent of the property factor plus five percent of the payroll factor plus ninety percent of the sales factor.

(v)

For taxable years beginning on or after January first, two thousand, one hundred percent of the sales factor.

(3)

Each manufacturing corporation with more than twenty-five employees, apportioning its income in accordance with the provisions of this subsection, as part of its tax return for each year, shall submit a report, whose form and substance shall be determined by the commissioner of revenue, that describes for each taxable year as of the last day of such taxable year the following:

(i)

the number, nature and wages of jobs added or lost in the commonwealth and worldwide from the previous taxable year;

(ii)

the nature and amount of any change in the property factor during the taxable year;

(iii)

the nature and amount of any change in the payroll factor in the taxable year;

(iv)

the dollar amount of revenue foregone by the increased weighting of the sales factor pursuant to this section as compared to the apportionment method in effect for the first taxable year beginning on or after January first, nineteen hundred and ninety-five;

(v)

volume of sales in the commonwealth and worldwide;

(vi)

taxable income in the commonwealth and worldwide;

(vii)

book value of plant, land and equipment in the commonwealth and worldwide;

(viii)

net capital investments in the commonwealth and worldwide;

(ix)

net assets;

(x)

capacity utilization; and

(xi)

debts, itemized by the following categories:

(a)

loans; and

(b)

mortgages.

The commissioner of revenue shall annually prepare a comprehensive report utilizing the information received in this paragraph and other sources describing and evaluating the impact, if any, of the utilization of the increased weighting of the sales factor upon the manufacturing industry. Said report shall contain only cumulative information for all manufacturing corporations submitting reports. Said report shall set forth for all manufacturing corporations submitting reports the cumulative totals worldwide and, where applicable, in the commonwealth of the items specified in clauses (i) to (xi) and the changes in such aggregate totals

from the previous taxable year. The commissioner's report shall be filed not later than October first of each year with the clerk of the senate and the clerk of the house of representatives who shall forward the same to their respective committees on ways and means and to the joint committee on taxation. Said report of the commissioner shall be a public record subject to the provisions of section ten of chapter sixty-six.

As used in this subsection and in subsections *(c)* and *(f)* the following words shall, unless the context otherwise requires, have the following meaning:

"Administration services", include, but are not limited to, clerical, fund or shareholder accounting, participant record keeping, transfer agency, book-keeping, data processing, custodial, internal auditing, legal and tax services performed for a regulated investment company, but only if the provider of such service or services during the taxable year in which such service or services are provided also provides or is affiliated with a person that provides management or distribution services to any regulated investment company.

"Affiliate", the meaning as set forth in 15 USC section a-2(a)(3)(C), as may be amended from time to time.

"Base period employment level", the number of qualified employees in this commonwealth of a mutual fund service corporation as of

January first, nineteen hundred and ninety-six, or if the mutual fund service corporation is one of the mutual fund service corporations filing a combined return for the tax year ending as of December thirty-first, nineteen hundred and ninety-six, the aggregate number of all qualified employees as of January first, nineteen hundred and ninety-six of all of the mutual fund service corporations participating in such combined return. If a mutual fund service corporation was not engaged in business in the commonwealth on January first, nineteen hundred and ninety-six, the base period employment level shall be the average employment level for the first two taxable years during which it is engaged in business in the commonwealth. In the event of the acquisition of a business or line of business or any other corporate restructuring that increases the number of qualified employees of the mutual fund service corporation, the base period employment level to be applied in the taxable year in which the acquisition or restructuring occurs and in all subsequent taxable years shall be increased to reflect was an increase. In the event of a divestiture of a line of business or other corporate restructuring that decreases the number of qualified employees of the mutual fund service corporation, the base period employment level to be applied in the taxable year in which such divestiture or other corporate restructuring occurs and in all subsequent taxable years shall be

recalculated to reflect such decrease only if the mutual fund service corporation can demonstrate that such divestiture or other corporate restructuring will not result in any reduction in the number of jobs in the commonwealth.

"Distribution services", include, but are not limited to, the services of advertising, servicing, marketing or selling shares of a regulated investment company, but, in the case of advertising, servicing or marketing shares, only where such service is performed by a person who is, or in the case of a close end company, was, either engaged in the services of selling regulated investment company shares or affiliated with a person that is engaged in the service of selling regulated investment company shares. In the case of an open end company, such service of selling shares must be performed pursuant to a contract entered into pursuant to 15 USC section a-15(b), as from time to time amended.

"Domicile", presumptively the shareholder's mailing address on the records of the regulated investment company. If, however, the regulated investment company or the mutual fund service corporation has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address said presumption shall not control. If the shareholder of record is a company which holds the shares of the regulated

investment company as depositor for the benefit of a separate account, then the shareholder shall be the contract owners or policyholders of the contracts or policies supported by the separate account, and it shall be presumed that the domicile of said shareholder is the contract owner's or policyholders mailing address to the extent that the company maintains such mailing addresses in the regular course of business. If the regulated investment company or the mutual fund service corporation has actual knowledge that the shareholder's principal place of business is different than the shareholder's mailing address said presumption shall not control.

"Employment level", the number of qualified employees of the mutual fund service corporation in the taxable year, or if the mutual fund service corporation is one of the mutual fund service corporations filing a combined return for such taxable year, the sum of the number of qualified employees of all such mutual fund service corporations in this commonwealth for the taxable year.

"Jobs commitment level", except as provided in subparagraph (b) of paragraph (4), for taxable years beginning on or after January first, nineteen hundred and ninety-seven, but before January first, nineteen hundred and ninety-eight, an employment level of one hundred and five percent of the base period employment level; for taxable years beginning on or after January first, nineteen

hundred and ninety-eight, but before January first, nineteen hundred and ninety-nine, an employment level of one hundred and ten percent of the base period employment level; for taxable years beginning on or after January first, nineteen hundred and ninety-nine, but before January first, two thousand, an employment level of one hundred and fifteen percent of the base period employment level; for taxable years beginning on or after January first, two thousand, but before January first, two thousand and one, an employment level of one hundred and twenty percent of the base period employment level; for taxable years beginning on or after January first, two thousand and one, but before January first, two thousand and two, an employment level of one hundred and twenty-five percent of the base period employment level; for taxable years beginning on or after January first, two thousand and two, but before January first, two thousand and three, an employment level of one hundred and twenty-five percent of the base period employment level. If a mutual fund service corporation was not engaged in business in the commonwealth on January first, nineteen hundred and ninety-six, for all taxable years beginning before January first, two thousand and three, the jobs commitment level shall be the base period employment level increased by five percent of the base period employment level for every

year after which the base period employment level is established.

"Management services", include, but are not necessarily limited to, the rendering of investment advice directly or indirectly to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company, or the selling or purchasing of securities constituting assets of a regulated investment company, and related activities, but only where such activity or activities are performed: (i) pursuant to a contract with the regulated investment company entered into pursuant to 15 USC section a-15(a), as from time to time amended; (ii) for a person that has entered into such contract with the regulated investment company, or (iii) for a person that is affiliated with a person that has entered into such contract with a regulated investment company.

"Mutual fund sales", taxable net income derived within the taxable year directly or indirectly from the rendering of management, distribution or administration services to a regulated investment company, including net income received directly or indirectly from trustees, sponsors and participants of employee benefit plans which have accounts in a regulated investment company.

"Mutual fund service corporation", any corporation doing business in the commonwealth which derives more than fifty percent of its gross income from the provision directly or indirectly of management, distribution or administration services to or on behalf of a regulated investment company and from trustees, sponsors and participants of employee benefit plans which have accounts in a regulated investment company.

"Number of qualified employees", the number of qualified employees who are employed by a mutual fund service corporation in the commonwealth as of the last day of a given taxable year.

"Number of qualified employees worldwide", the total number of qualified employees worldwide who were employed by the mutual fund service corporation on a specified date.

"Qualified employee in this commonwealth", an individual who: (i) is employed by a mutual fund service corporation; (ii) works on a full-time basis with a normal work week of thirty or more hours; (iii) at the inception of the employment relationship does not have a termination date which is either a date certain or determined with reference to the completion of some specified scope of work, (iv) is eligible to receive employee benefits including, but not limited to, paid holidays, vacation and unemployment benefits; and (v) is subject to Massachusetts income tax withholding. Three or fewer

individuals who collectively fulfill the requirement of clause (ii) and who each meet the requirements of clauses (i), (iii), (iv) and (v) shall be counted as one qualified employee for purposes of this section.

"Qualified employee worldwide", an individual who meets the criteria in subsections (i) to (iv), inclusive, of the definition of "Qualified employee in this commonwealth." Three or fewer individuals who collectively fulfill the requirement of clause (ii) of said definition of "Qualified employee in this commonwealth." and who each meet the requirements of clauses (i), (iii) and (iv) of said definition of "Qualified employee in this commonwealth" shall be counted as one qualified employee for purposes of this section.

"Regulated investment company", the meaning as set forth in section 851 of the Internal Revenue Code as amended and in effect for the taxable year.

(2)

Notwithstanding any other provision of the General Laws, any mutual fund service corporation moving income from mutual fund sales to one or more regulated investment companies with shareholders domiciled within and without this commonwealth shall apportion such income pursuant to the provisions of subsection *(c)*. Furthermore, any such mutual fund service corporation whose employment level in the current

taxable year is equal to or greater than its jobs commitment level for such taxable year and who satisfies the requirements of paragraphs (3) and (4), or any such mutual fund service corporation for which the jobs commitment level requirement no longer applies shall apportion such income by multiplying it by one hundred percent of the sales factor, subject to the provisions of clause (i). The provisions of paragraph (2) of subsection *(m)* shall take effect as of July first, nineteen hundred and ninety-seven. For taxable years beginning on or after January first, nineteen hundred and ninety-seven and including July first, nineteen hundred and ninety-seven, a mutual fund service corporation shall apportion its taxable income to this commonwealth for such taxable year by multiplying taxable net income by the percentage calculated by weighting the apportionment percentage determined under subsection *(c)*, as in effect before July first, nineteen hundred and ninety-seven, by the number of days in such taxable year preceding July first, nineteen hundred and ninety-seven and by weighting the apportionment percentage determined under said paragraph (2) of said subsection *(m)* by the number of days in such taxable year on and after July first, nineteen hundred and ninety-seven.

(3)

Notwithstanding a mutual fund service corporation's failure to achieve its jobs

commitment level in the taxable year, the percentage set forth in the second paragraph of paragraph (2) of subsection *(m)* may be applied, where the failure to achieve the jobs commitment level for any taxable year is demonstrated by the mutual fund service corporation to be a direct result of adverse economic conditions in that taxable year.

(a)

Adverse economic conditions can affect only one taxable year except as set forth in subparagraph (b) and (c). Adverse economic conditions shall exist only where during any twelve month period ending during the taxable year, either: (A) the Standard & Poor's 500 Stock Index decreases ten percent or more compared to its level at the beginning of such twelve month period or (B) the average daily trading volume on the New York Stock Exchange decreases fifteen percent or more compared to the average over the preceding twelve months; or (C) at any time during the taxable year, the total assets under management of the mutual funds served by the mutual fund service corporation decreases twelve and one-half percent or more compared to such total assets under management twelve months earlier.

(b)

If a mutual fund service corporation demonstrates that failure to achieve the jobs commitment level for one taxable year was

the direct result of an adverse economic condition, such corporation may decrease its jobs commitment level by five percent of the base period employment level for all subsequent taxable years prior to the first taxable year beginning on or after January first, two thousand and two.

(c)

If a mutual fund service corporation demonstrates that failure to achieve the jobs commitment level for more than one taxable year was the direct result of an adverse economic condition, such corporation may decrease its jobs commitment level by five percent of the base period employment level for each taxable year in which an adverse economic condition was established for all subsequent taxable years prior to the first taxable year beginning on or after January one, two thousand and two. However, for each taxable year beginning on or after January first, two thousand and two, but prior to the first taxable year beginning on or after January first, two thousand and four, the jobs commitment level shall be an employment level equal to the sum of: (i) the jobs commitment level for the most recent taxable year immediately prior to such year for which an adverse economic condition was not established; and (ii) five percent of the base period employment level.

(4)

For the purposes of determining compliance with the provisions of this subsection, each mutual fund service corporation that seeks to rely on the provisions of this subsection for the taxable year in question shall submit, as part of its tax return, a report, with such supporting documentation as the commissioner may require, containing the following:

(i)

the number, nature, and aggregate wages of the qualified employees in this commonwealth and qualified employees worldwide as of the end of the taxable year and the number of jobs added or lost as compared to the previous taxable year;

(ii)

the number of the qualified employees in this commonwealth as of the last day of the taxable year sorted by place of employment;

(iii)

the base period employment level;

(iv)

the volume of sales attributable to this commonwealth and worldwide;

(v)

the taxable income in this commonwealth;

(vi)

net assets under management in this commonwealth and worldwide; and

(vii)

the median income of all of qualified employees in the commonwealth and of all of its qualified employees worldwide.

The information provided by each individual mutual fund service corporation shall be treated as confidential under the provisions of section twenty-one of chapter sixty-two C. Said information shall be used by the commissioner of revenue to prepare a comprehensive annual report setting forth the changes in the aggregate from the previous taxable year for each of the items listed above. The commissioner's report shall also set forth any recommendations the commissioner may have for any amendments to the provisions of this section, and the reasons for any such recommendations. The commissioner's report shall be filed by October first of each year with the clerk of the senate and the clerk of the house of representatives who shall forward the same to the respective committees on ways and means and the joint committee on taxation.

(5)

The commissioner of revenue shall promulgate regulations implementing the provisions of this subsection.

* * *

GENERAL LAWS OF THE COMMONWEALTH OF MASSACHUSETTS, 1932, CHAPTER 63 TAXATION OF CORPORATIONS, Foreign Corporations.

Sec. 39. Excise on foreign corporations.

Except as otherwise provided herein, every foreign corporation, exercising its charter, or qualified to do business or actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay, on account of each taxable year, the excise provided in subsection *(a)* or *(b)* of this section, whichever is greater, except that a foreign insurance mutual holding company organized pursuant to the laws of the state in which it is established shall pay, on account of each taxable year, only the excise provided by clause (2) of subsection (a) or subsection (b), whichever is greater.

The excise levied herein is due and payable on any one or all of the following alternative incidents:

(1)

> The qualification to carry on or do business in this state or the actual doing of business within the commonwealth in a corporate form. The term "doing business" as used herein shall mean and include each and every act, power, right, privilege, or immunity exercised or enjoyed in the commonwealth, as an incident to or by virtue of the powers and privileges acquired by the

nature of such organizations, as well as, the buying, selling or procuring of services or property.

(2)

The exercising of a corporation's charter or the continuance of its charter within the commonwealth.

(3)

The owning or using any part or all of its capital, plant or other property in the commonwealth in a corporate capacity.

It is the purpose of this section to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the commonwealth, of the powers, rights, privileges and immunities derived by reason of the corporate form of existence and operation.

In the case of a corporation whose taxable year is a period of less than twelve calendar months, the portion of the amount determined under clause (1) of subsection *(a)* shall be multiplied by a fraction whose numerator is the number of months included in the taxable year and whose denominator is twelve.

* * *

(a)

An amount equal to the sum of: –

(1)

Seven dollars per thousand upon the value of –

(i)

its tangible property as determined to be taxable under paragraph 7 of section thirty if a tangible property corporation, or

(ii)

its net worth as determined to be taxable under paragraph 9 of section thirty if an intangible property corporation; and

(2)

Eight and thirty-three one hundredths per cent of its net income determined to be taxable in accordance with the provisions of this chapter.

* * *

(b)

Four hundred dollars.

A foreign corporation shall not be subject to tax under this chapter if the foreign corporation is engaged in the business of selling tangible personal property and taxation of that foreign corporation under this chapter is precluded by the Constitution or laws of the United States, or would be so

precluded except for the fact that the foreign corporation stored tangible personal property in a licensed public storage warehouse, provided, that no portion of any warehouse which is owned or leased by a consignor or consignee of the tangible personal property shall be deemed a licensed public warehouse.

* * *

APPENDIX E

Reg. 830 CMR 63.38.1. Apportionment of Income.

* * *

(9) *Sales Factor.* The sales factor is a fraction whose numerator is total sales of the taxpayer in Massachusetts during the taxable year and whose denominator is total sales of the taxpayer everywhere during the taxable year. A taxpayer's total sales are its gross receipts, with the exception of the items specifically excluded below.

* * *

(d) *Sales Other Than Sales of Tangible Personal Property in Massachusetts.*

1. *General Rule.* Gross receipts from sales, other than sales of tangible personal property, are attributed to Massachusetts if the income-producing activity that gave rise to the receipts was performed wholly within Massachusetts. If income-producing activity is performed both within and without Massachusetts and if the costs of performing the income-producing activity are greater in Massachusetts than in any other one state, then gross receipts are attributed to Massachusetts.

2. *Income-producing Activity Defined.* For purposes of this subsection, an income-producing activity is a transaction, procedure, or operation directly engaged in by a taxpayer which results in a separately identifiable item of income. In general, any activity whose performance creates an obligation of a

particular customer to pay a specific consideration to the taxpayer is an income-producing activity. However, except insofar as required by 830 CMR 63.38.1(9)(d)3.c., below, (relating to the licensing or sale of intangibles), income-producing activity includes only the activities of the taxpayer whose income is being apportioned. Except as provided in 830 CMR 63.38.1(9)(d)3.c., below, income-producing activity does not include activities performed on behalf of a taxpayer by another person, such as services performed on its behalf by an independent contractor or by any other party whose activities are not attributable to the taxpayer for purposes of determining tax jurisdiction under 830 CMR 63.39.1. For example, in the case of a taxpayer who brokers the sale of services that are performed by third parties, the income-producing activity includes only the brokerage activity and not the ultimate services performed, provided that the performance of the ultimate service by the third party is not considered an activity of the taxpayer under 830 CMR 63.39.1 for purposes of determining whether the taxpayer is taxable in the state where the service is performed.

3. *Specific Income-Producing Activities.*

* * *

c. Income-producing activity includes the licensing of intangible property (other than securities) to another party. Intangible property generally includes copyrights, patents, trademarks, trade names, trade secrets, good will, rights, and similar

intangibles, provided that intangible property licensed in conjunction with the sale of tangible property is treated as the sale of tangible property, and provided that sales of partnership interests are governed by 830 CMR 63.38.1(9)(d)3.d. Where a taxpayer licenses intangible property to another party and receives royalties or similar payments for the use of the intangible property, income-producing activity includes the use of the intangible property by such other party. Each use of the intangible property that results in a separately identifiable item of income for the taxpayer shall be a separate income-producing activity and shall be considered a separate use of the intangible property for purposes of 830 CMR 63.38.1(9)(d). In the case of licenses or similar arrangements compensated by a percentage of the licensee's sales, each sale by the licensee that results in a payment to the licenser whether separate from or combined with other payments is an income producing activity.

Gross receipts from the licensing of intangible property are attributable to Massachusetts if the property is used by the licensee solely in Massachusetts. If the licensee uses the intangible property in more than one state, the gross receipts from the licensing are attributable to Massachusetts if the use of the property by the licensee in Massachusetts exceeds its use of the property in any other one state. A sale that resembles a license, such as a contingent sale (a sale in which the receipts from the sale of the intangible property are contingent

upon the purchaser's use of the property), will be treated as a license under this 830 CMR 63.38.1(9)(d)3.c.

i. For purposes of 830 CMR 63.38.1(9)(d)3.c., the use of intangible property is deemed to occur in the state of commercial domicile of the licensee unless the taxpayer or the Commissioner demonstrates that the property is actually used in or geographically associated with another specific state, and that such actual use or association exceeds the use in or association with the state of commercial domicile.

Examples of actual use include the use of patents or trade secrets in a manufacturing process, or the advertisement or retail display of a trademark or trade name. Actual use shall not include activities of sublicensees, provided that the Commissioner may consider activities of sublicensees in the case of licensing, sublicensing, or other sales agreements among affiliated taxpayers.

Examples of geographic association with a specific state include marketing rights, rights under a covenant not to compete, or broadcast rights, if such rights are restricted to a specific geographic area.

ii. Licensing of canned software, transferred on a tangible medium, for purposes other than commercial reproduction, shall be treated as the sale of tangible personal property, rather than as either the licensing of intellectual property or the performance of a service.

* * *

Reg. 830 CMR 63.39.1. Corporate Nexus.

(1) *General.* (a) 830 CMR 63.39.1 describes the circumstances under which a foreign corporation is subject to the tax jurisdiction of Massachusetts under M.G.L. c. 63, §39.

(b) 830 CMR 63.39.1 is organized as follows:

1. General
2. Definitions
3. General Rule For Evaluating Corporate Tax Jurisdiction
4. Activities Within the Scope of M.G.L. c. 63, §39
5. Exception for Solicitation Activities Protected By P.L. 86-272
6. Other Exceptions
7. Independent Contractors
8. Corporate Partners
9. Nexus Determinations
10. Examples

(2) *Definitions.*

Commissioner, the Commissioner of the Massachusetts Department of Revenue or the Commissioner's duly authorized representative.

Corporate Form, a form of organization recognized in Massachusetts as that of foreign corporation under M.G.L. c. 63, §30(2), whether or not

the entity is described as a corporation by the state under whose laws the entity or organized.

Documentary Evidence, journals, books of account, invoices, expense reports, or other records that are maintained by the taxpayer in the regular course of its business. Generally, an affidavit or other document prepared in anticipation of, or in response to a tax audit, examination, or litigation is not documentary evidence.

Employee, any person who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. A person is presumed to be an employee of a foreign corporation, rather than an independent contractor, if the foreign corporation treats that person as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act.

Foreign Corporation, an entity defined as a foreign corporation under M.G.L. c. 63, §30(2).

Independent Contractor, an independent contractor as defined in 830 CMR 63.39.1(7).

Licensed Public Warehouse, any building or part thereof maintained as a business for the public storage of goods, wares, and merchandise by a warehouseman licensed under the provisions of M.G.L. c. 105, provided however that any portion of a warehouse owned or leased by a consignor or consignee of tangible personal property stored in the

warehouse is not a licensed public warehouse for purposes of M.G.L. c. 63, §39.

Missionary sales activity, generating retail demand for the products of a manufacturer or distributor (and indirectly generating wholesale orders for those products) by promoting the products to retailers who typically order the products from a wholesaler or other middleman.

Office, a permanent or temporary location where a corporation makes sales or holds itself out to the public as conducting business. An in-home office of a corporation's sales representative is generally not an 'office' of the corporation for purposes of 830 CMR 63.39.1, provided that the representative does not publicly hold himself out as doing business on behalf of the corporation at that location, either by publishing the home address as a corporate business address or through other actions.

Partnership, any entity considered to be a partnership under common law rules, under the provisions of the Uniform Partnership Act, or under the provisions of the Uniform Limited Partnership Act. A corporate trust that is subject to the provisions of M.G.L. c. 62 is not considered to be a partnership for purposes of 830 CMR 63.39.1.

Representative, an employee of a corporation, or any person who otherwise acts on behalf of the corporation, provided that an independent contractor as defined in 830 CMR 63.39.1(7) is not a representative.

Sample or display area, a temporary location, such as a hotel room or trade show exhibit, where representatives of a foreign corporation exhibit samples, but do not make sales, approve orders for sales, or conduct any of the activities listed in 830 CMR 63.39.1(4)(d).

Samples, representative samples of the product of a foreign corporation that are used in sales demonstrations or are distributed in limited quantities, without charge, to acquaint existing or prospective customers with the corporation's products. Gemstones or other unique items held for sale by a sales representative are not samples.

(3) *General Rule for Evaluating Corporate Tax Jurisdiction.* M.G.L. c. 63, §39, imposes an excise upon all foreign corporations that enjoy, under the protection of the laws of the Commonwealth, the powers, rights, privileges, and immunities derived from the corporate form of existence and operation. The Commissioner will construe M.G.L. c. 63, §39, as asserting the tax jurisdiction of Massachusetts to the extent permitted by the Constitution and laws of the United States, unless a specific statutory exclusion from taxation exists. In general, a foreign corporation is subject to the tax jurisdiction of Massachusetts under M.G.L. c. 63, §39, if it engages in any of the activities listed in 830 CMR 63.39.1(4), unless those activities fall within the exceptions described in 830 CMR 63.39.1(5) (relating to P.L. 86-272) or 830 CMR 63.39.1(6) (other exceptions).

(4) *Activities Within the Scope of M.G.L. c. 63, §39.* Except as provided in 830 CMR 63.39.1(5)-(6), a foreign corporation must file a return in Massachusetts and pay the associated excise if any one or more of the following apply:

(a) the corporation is qualified to do business in Massachusetts under M.G.L. c. 181, §4;

(b) the corporation actually does business in Massachusetts, whether or not it has qualified to do so. For purposes of M.G.L. c. 63, §39, "doing business" includes:

1. the buying, selling or procuring of services or property;

2. the execution of contracts;

3. the exercise or enforcement of contract rights;

4. the maintenance of a place of business;

5. the employment of labor;

6. each and every other act, power, right, privilege, or immunity exercised or enjoyed in the Commonwealth as an incident to or by virtue of the powers and privileges acquired through corporate form;

(c) the corporation exercises or continues its charter within Massachusetts;

(d) the corporations owns or uses any part of all of its capital, plant, or other property in the Commonwealth in a corporate capacity (as opposed to a strictly fiduciary capacity). Without limitation, a corporation owns or uses property in Massachusetts if:

1. the corporation owns property that is held by another in Massachusetts under a lease, consignment, or other arrangement;

2. the corporation uses property in Massachusetts that it holds under a lease, license, or other arrangement;

3. the corporation maintains a stock of goods in Massachusetts (see, however, 830 CMR 63.39.1(6)(c), regarding property stored in a public warehouse).

(5) *Exception for Solicitation Activities Protected By P.L. 86-272.*

(a) *General; Preemption of State Law.* A foreign corporation whose activities fall within those described in M.G.L. c. 63, §39, and 830 CMR 63.39.1(4) nevertheless is not subject to Massachusetts taxation if Massachusetts is precluded from exercising its jurisdiction by P.L. 86-272 (15 U.S.C. §§381 *et seq.*). P.L. 86-272 currently precludes the imposition of the excise under M.G.L. c. 63, §39, upon a foreign corporation if the sole activity of the corporation in Massachusetts is the solicitation by the corporation's representatives (in the name of the corporation or in the name of a prospective customer)

of orders for the sale of tangible personal property, provided that the orders are sent outside Massachusetts for approval or rejection, and provided that the orders are filled by shipment or delivery by common carrier or contract carrier from a point outside of Massachusetts. Some examples of common solicitation activities are listed in 830 CMR 63.39.1(5)(c).

(b) *Scope of P.L. 86-272.* P.L. 86-272 restricts states' tax jurisdiction with respect to sales to solicitation activities only if the taxpayer's activity is limited to solicitation of orders for the sale of intangible personal property. The protection from state net income taxes provided by P.L. 86-272 does not apply to solicitation activities under the following circumstances:

1. A combination of solicitation activities and other unprotected activities is not protected by P.L. 86-272. If a corporation engages both in protected solicitation activities and in any other activity that is not solicitation of orders for the sale of tangible personal property, it may not claim the immunity provided by P.L. 86-272;

2. Solicitation of orders for the sale or provision of services is not protected by P.L. 86-272. A corporation may not claim the immunity provided by P.L. 86-272 if it sells or provides a mixture of services and tangible personal property to its customers. Typical examples of the sale of a mixture of services and tangible personal property are photographic

development, the fabrication of a customer's materials, the installation of equipment, and the provision of architectural or engineering services;

3. Solicitation of orders for the sale, lease, rental, license, or other disposition of real property or intangibles is not protected by P.L. 86-272.

(c) *Activities Normally Considered to be Solicitation.* The following are examples of activities that ordinarily fall within the scope of "solicitation" under P.L. 86-272.

1. Advertising campaigns incidental to missionary activities;

2. Carrying samples only for display or for distribution without charge or other consideration;

3. Owning or furnishing automobiles to sales representatives, provided that the vehicles are used exclusively for solicitation purposes;

4. Passing inquiries and complaints on to home office;

5. Incidental and minor advertising, i.e., a notice in a newspaper that a sales representative will be in town at a certain time;

6. Missionary sales activities;

7. Checking of customers' inventories (for re-order, but not for other purposes);

8. Maintaining a sample or display area for an aggregate of 14 calendar days or less during the tax year, provided that no sales or other activities inconsistent with solicitation take place;

9. Soliciting of sales by an in-state resident representative of the taxpayer; provided the representative maintains no in-state sales office or place of business;

10. Training sales representatives or holding periodic meetings of sales representatives.

(d) *Activities That Are Not Solicitation.* The following are examples of activities that fall outside of the scope of "solicitation" and are not protected by P.L. 86-272 unless they are *de minimis* within the meaning of *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.,* 112 S. Ct. 2447 (1992).

1. Making repairs or providing maintenance;

2. Collecting delinquent accounts;

3. Investigating creditworthiness;

4. Installation or supervision of installation;

5. Conducting training courses, seminars or lectures;

6. Providing engineering functions;

7. Handling customer complaints (other than by referral to home office);

8. Approving or accepting orders;

9. Repossessing property;

10. Securing deposits on sales;

11. Picking up or replacing damages or returned property, including stale or unsalable inventory;

12. Hiring, training, or supervising personnel (other than the training of sales representatives);

13. Providing shipping information and coordinating deliveries;

14. Carrying samples for sale, exchange or distribution in any manner for consideration or other value;

15. Holding meetings of directors, officers, or employees;

16. Supervising the operations of a franchise or similar party;

17. Monitoring, inspecting, or approving a work performed by an independent contractor under a warranty or similar contractual arrangement;

18. Maintaining sample or display area at one location in excess of 14 calendar days during the tax year;

19. Owning, leasing, maintaining or otherwise using any of the following facilities or property in-state:

a. Repair shop;

b. Parts department;

c. Purchasing office;

d. Employment office;

e. Warehouse;

f. Stock of goods (but see 830 CMR 63.39.1(6)(c) regarding property stored in a public warehouse);

g. Mobile stores, i.e., trucks with driver salespersons;

h. Real property or fixtures of any kind;

20. Consigning tangible personal property to any person, including an independent contractor;

21. Maintaining, by either an in-state or an out-of-state resident representative, an office or place of business;

22. Qualifying to do business in Massachusetts;

23. Owning an interest in any partnership, grantor trust, or other pass-through entity whose activities, if conducted directly by a foreign corporation, would give Massachusetts jurisdiction over the foreign corporation under the provisions of 830 CMR 63.39.1(4), unless the activities of the pass-through entity are limited to solicitation protected by P.L. 86-272.

(e) *Rules of Construction.* Where the activities of a foreign corporation fail within the scope of "solicitation" within the meaning of P.L. 86-272 is a factual determination. The examples of activities provided in 830 CMR 63.39.1(5)(c) and (d), respectively, are intended as guidelines. They are not exhaustive and will not precisely describe the activities of many foreign corporations. In applying the guidelines to the particular circumstances and activities of individual foreign corporations, the Commissioner will employ the following rules of construction:

1. The term "solicitation" includes only actual requests for purchases and activities that are entirely ancillary to requests for purchases. An activity is entirely ancillary to the requesting of purchases only if it serves no independent business purpose apart from its connection to the soliciting of orders.

2. Activities conducted by a foreign corporation with respect to a particular order generally do not constitute "solicitation" if they occur after the order has been placed.

3. The effect of the activities listed in 830 CMR 63.39.1(5)(d) is cumulative. When determining whether a taxpayer's activities in excess of solicitation may be *de minimis*, all of these activities must be considered as a whole.

4. If the Commissioner believes that a taxpayer engages in any activity listed in 830 CMR 63.39.1(5)(d), in Massachusetts, the Commissioner will require the

taxpayer to carry the burden of substantiating any claim that its activities were *de minimis*. Documentary evidence will be given substantial weight in establishing the nature and extent of the taxpayer's activities. Affidavits or other evidence not contemporaneous with the events in question will be given little weight.

(As added January 1, 1993.)

(6) *Other Exceptions.*

(a) *General.* A foreign corporation is not subject to the excise under M.G.L. c. 63, §39, if its contacts with Massachusetts are limited exclusively to one or more of the activities listed in 830 CMR 63.39.1.(6)(b)-(e). The activities listed below will not create jurisdiction even if they also fall within the scope of activities that would otherwise create jurisdiction under 830 CMR 63.39.1(4). For purposes of applying this subsection, the qualification to do business in Massachusetts under M.G.L. c. 181 is considered a contact with the Commonwealth that is independent of any other contacts that the foreign corporation may have with Massachusetts or activities that the foreign corporation may conduct in Massachusetts.

(b) *Federal Limitations (Other than P.L. 86-272).* A foreign corporation's activities will not subject it to the jurisdiction of Massachusetts under M.G.L. c. 63, §39, if the Constitution or laws of the United States preclude the exercise of jurisdiction. For discussion of activities currently protected from the exercise of

state tax jurisdiction by P.L. 86-272, see 830 CMR 63.39.1(5).

(c) *Property in Transit or Public Warehouse.* A foreign corporation is not subject to the corporate excise under M.G.L. c. 63, §39, because of its ownership of tangible personal property in actual transit through Massachusetts in the possession and control of a common or contract carrier (provided, however, that this provision shall not preclude the exercise of jurisdiction over foreign carriers whose vehicles enter Massachusetts) or because of its ownership of tangible personal property stored in a licensed public warehouse in Massachusetts. The exemption from taxation provided by M.G.L. c. 63, §39, for the ownership of goods stored in a licensed public warehouse will not be lost because of the shipment of those goods by common or contract carriers from the public warehouse to locations either within or outside of Massachusetts (provided, however, that the exemption does not extend to foreign carriers whose vehicles enter Massachusetts).

(d) *Ownership of Shares.* A foreign corporation is not subject to the corporate excise under M.G.L. c. 63, §39, because of its mere ownership of shares of a corporation that does business in Massachusetts.

(e) *Maintenance of Accounts.* A foreign corporation is not subject to the corporate excise under M.G.L. c. 63, §39, because of its depositing of funds or maintenance of securities brokerage accounts with financial institutions, unrelated to

the foreign corporation, that do business in Massachusetts.

(7) *Independent Contractors.* For the purposes of determining whether a foreign corporation is subject to the excise under M.G.L. c. 63, §39, the activities of employees, agents, or representatives, however designated, of the foreign corporation will be imputed to the corporation. An agent or representative may be an individual, corporation, partnership, or other entity. Activities of an independent contractor will not be imputed to the corporation. For purpose of 830 CMR 63.39.1(7), a person is an independent contractor only if all of the following conditions are met.

(a) The person is not an employee of the foreign corporation.

(b) The person is not subject, in the performance of activities on behalf of the foreign corporation, to the supervision or control (whether or not exercised) of the foreign corporation or any of that corporation's representatives. Whether a purported independent contractor is subject to the supervision or control of a foreign corporation or any of its representatives within the meaning of 830 CMR 63.39.1(7)(b) is a question of fact.

(c) The person holds himself out to the public as an independent contractor in the regular course of its business.

(d) The person must regularly act on behalf of at least one bona fide principal apart from the foreign corporation. Partners, corporate affiliates, or other closely related parties are not separate principals for purposes of 830 CMR 63.39.1(7)(d).

(e) The person may not approve orders on behalf of the foreign corporation or otherwise execute contracts on behalf of the foreign corporation, provided that:

1. to the extent permitted by P.L. 86-272, a person may sell or solicit orders for the sale of tangible personal property on behalf of a foreign corporation without losing the status of an independent contractor, and

2. a financial institution that holds itself out to the public as an investment advisor, providing investment advice and/or management services, including portfolio accounting or bookkeeping services, custodial services, and related financial services to unrelated third parties shall not lose the status of an independent contractor by virtue of any authority that it may have to execute contracts related to the purchase, sale, or management of securities on behalf of those third parties.

(8) *Corporate Partners.*

(a) *General Rule – Partnership Activities Attributed to Partners.* Except as provided by 830 CMR 63.39.1(8)(b)-(d), a foreign corporation uses its capital in Massachusetts, does business in

Massachusetts, and is subject to the excise under M.G.L. c. 63, §39, if the corporation is a general or limited partner in a partnership whose activities, if conducted directly by a foreign corporation, would subject that corporation to the corporate excise under the provisions of M.G.L. c. 63, §39. In the case of a tiered partnership, as defined in 830 CMR 63.39.1(8)(b)3, the activities of the partnership(s) occupying the lower tier(s) of a tiered partnership arrangement are imputed, proportionally, to all partners holding interests in partnership(s) occupying higher tier(s).

(b) *Exception for Certain Partnerships Dealing in Securities.* A foreign corporation is not subject to the excise under M.G.L. c. 63, §39, by reason of its status as a limited partner in a partnership that is engaged exclusively in buying, selling, dealing in, or holding securities on its own behalf, and not as a broker, provided that the foreign corporation is not otherwise subject to the excise under M.G.L. c. 63, §39. See generally M.G.L. c. 62, §17.

1. In general, the exception in 830 CMR 63.39.1(8)(b) does not extend to an upper tier partnership in a tiered partnership arrangement, merely by virtue of the tiered structure. However, an upper tier partnership that is engaged exclusively in buying, selling, dealing in, or holding securities (apart from any limited partnership interests) in its own behalf, and not as a broker, may include among the securities in its portfolio, limited partnership interests in unrelated partnerships that conduct

business activity in Massachusetts, without subjecting its corporate limited partners to the excise under M.G.L. c. 63, §39.

2. If an upper tier partnership in a tiered partnership arrangement is a limited partner of a lower tier partnership that is engaged exclusively in buying selling dealing in, or holding securities on its own behalf, and not as a broker, the activities of the lower tier partnership will not, in themselves, subject corporate partners of the upper tier partnership to the excise under M.G.L. c. 63, §39.

3. A tiered partnership arrangement is one in which some or all of the interests in one partnership (lower tier partnership) are held by a second partnership (upper tier partnership). A tiered partnership arrangement may have two or more tiers.

(c) *Exception for Publicly Traded Partnerships.* A foreign corporation that holds a limited partnership interest in a publicly traded partnership, as defined in Code §7704, that conducts business activity in Massachusetts, is not subject to the excise under M.G.L. c. 63, §39, unless the activities of that foreign corporation otherwise establish nexus with Massachusetts.

(d) *De Minimis Exception.* Under circumstances specified in 830 CMR 63.39.1(8)(d)1.-2., the Commissioner ordinarily will treat the holding of a limited partnership interest by a foreign corporation as a *de minimis* connection with Massachusetts and will not seek to impose the excise under M.G.L. c. 63,

§39, on that corporate limited partner, despite the conduct of business activities by the partnership in Massachusetts. This *de minimis* rule applies only to foreign corporations that, apart from their limited partnership holdings, are not subject to the excise under M.G.L. c. 63, §39. The *de minimis* rule does not apply to apply to any limited partner that is subject to tax under M.G.L. c. 62 or to any general partner. The application of the *de minimis* rule is subject to the ownership attribution principles and other conditions stated in 830 CMR 63.39.1(8)(d)3.-4.

1. The Commissioner ordinarily will treat a limited partnership interest of a foreign corporation as a *de minimis* connection with Massachusetts if the foreign corporation owns less than a five percent interest in the partnership and if neither the Massachusetts property of the partnership, nor its Massachusetts payroll, nor its Massachusetts sales, when multiplied by the foreign corporation's interest in the partnership, exceeds $10,000. The Massachusetts property, payroll, and sales of the partnership shall be calculated under the rules provided in M.G.L. c. 63, §38. The interest of a limited partner in a partnership shall be its distributive share of the partnership's income, gain, loss, or credit, (whichever may be greatest) determined pursuant to Code §704.

2. Under extraordinary circumstances, the Commissioner may agree that a limited partnership holding of a foreign corporation is a *de minimis* connection with Massachusetts, even if the test

stated in 830 CMR 63.39.1(8)(d)1. is not satisfied. In order to obtain the Commissioners agreement to *de minimis* treatment under 830 CMR 63.39.1(8)(d)2., a foreign corporation must establish to the Commissioner's satisfaction, during the course of an audit, by application for abatement, or by a determination under 830 CMR 63.39.1(9), that under the particular facts and circumstances applicable to the foreign corporation and the limited partnership, the connection between the foreign corporation and the Commonwealth is so inconsequential that the imposition of the corporate excise on the foreign corporation would constitute an unconstitutional extension of the tax jurisdiction of Massachusetts.

3. For purposes of applying the *de minimis* rule under 830 CMR 63.39.1(8)(d), a corporate limited partner is treated as owning all interests in a partnership that it owns either directly or indirectly, including all interests of any party whose direct or indirect stock ownership would be attributed to the corporate limited partner under the provisions of section 318 of the Internal Revenue Code. Furthermore, if a corporation owns (or is treated as owning) limited partnership interests in two or more partnerships that conduct business activity in Massachusetts, other than publicly traded partnerships as defined by Code §7704, the Massachusetts property, payroll, and sales represented by those interests, as calculated above, must be aggregated when applying the *de minimis* rule.

4. Any corporate limited partner that claims not to be subject to the excise under M.G.L. c. 63, §39, because of the *de minimis* rule stated in 830 CMR 63.39.1(8)(d) bears the burden of establishing its claim to the Commissioner's satisfaction. In order to provide its corporate limited partners with the information necessary to make a *de minimis* calculation, any partnership that is required to file Massachusetts Form 3 and that has limited interest held by foreign corporations shall complete Part III of that Form (Income Apportionment) and shall provide a copy of the completed form to any partner that requests one.

Example. The following example illustrates the provisions of 830 CMR 63.39.1(8)(d):

Some Place Partners, L.P., (Partnership) is a limited partnership that owns an office building at One Some Place in Boston. The Partnership purchased the property for $5 million and receives $500,000 gross annual rent. The partnership has no payroll and no other property or sales in Massachusetts. Corporation X, a foreign corporation, is a limited partner with a one percent capital and income interest in the Partnership. Corporation X has no other contacts with Massachusetts. Corporation X is subject to excise under M.G.L. c. 63, §39, and does not qualify for the *de minimis* exception of 830 CMR 63.39.1(8)(d) because the Massachusetts property attributable to Corporation X exceeds $10,000. Specifically: 0.01 x $5,000,000 = $50,000.

(e) *Effective Date.* The provisions of 830 CMR 63.39.1(8), shall apply to taxable years commencing on or after the effective date of this regulation, 830 CMR 63.39.1.

(f) *Presumption of Separate Accounting.* If a foreign corporation is subject to the tax jurisdiction Massachusetts under M.G.L. c.63, §39, only by virtue of its status as a limited partner of a partnership that conducts business in Massachusetts, and if the foreign corporation owns no more than 50% of the interests in the partnership, the Commissioner will presume that income received by the corporation from sources other than either the partnership or the disposition of its limited partnership interest is not derived from business activity carried on within the Commonwealth within the meaning of M.G.L. c.63, §38. Unless this presumption is rebutted either by the Commissioner or by the taxpayer, the Commissioner will require the foreign corporation to account separately for its partnership income and to apportion this separate income to Massachusetts in accordance with the rules of M.G.L. c. 63, §38 or 42, using only the partnership's property, payroll, and sales to determine an apportionment percentage. The separate accounting shall apply both to the determination of income subject to apportionment under M.G.L. c.63, §38 or 42, and to the determination of the property measure of excise under M.G.L. c.63, §39(a)(1).

Either the Commissioner or a taxpayer may rebut the presumption of separate accounting by

demonstrating that the corporate limited partner and the partnership are engaged in a unitary business. If a corporate limited partner has engaged in a unitary business with the partnership in one or more taxable years, the corporation may not separately account in any taxable year for the income it derives from the partnership. Instead, the foreign corporation shall apportion to Massachusetts all income derived from business activity carried on within the Commonwealth, including income derived from its partnership interest, in accordance with the rules of M.G.L. c.63, §38 or 42 using the corporation's own property, payroll, and sales plus its *pro rata* portion of the partnership's property, payroll, and sales to determine an apportionment percentage.

If a foreign corporate limited partner engages in a unitary business with its partnership, the activities of the partnership shall be deemed to be activities of the limited partner for purposes of determining whether the taxation of the limited partner is precluded by P.L. 86-272.

(9) *Nexus Determinations.*

(a) *Applications.* A foreign corporation may apply to the Commissioner for a determination of whether the corporation is subject to tax under M.G.L. c.63, §39, in a particular taxable year. A request for a nexus determination for a taxable year must be mailed to the Commissioner, at the address stated below, on or before the last day of the first quarter of the taxpayer's taxable year. The request

should generally conform to the requirements of a request for a letter ruling under 830 CMR 62C.3.2, and, in addition, the corporation must complete a nexus questionnaire provided by the Commissioner. The Commissioner may choose to treat any request for a nexus determination as a letter ruling application and may issue and publish such a ruling as provided by 830 CMR 62C.3.2, but nexus determinations generally will not be published.

Foreign corporations that wish to request a nexus determination should write to:

Massachusetts Department of Revenue

Rulings and Regulations Bureau, Room 703

100 Cambridge Street

Boston, MA 02204

(b) *When Nexus Determinations Will Be Issued.* The Commissioner ordinarily will make a nexus determination prospectively, regarding business activity that a taxpayer has not yet undertaken in Massachusetts, after receiving a proper request, but the Commissioner may decline to make a determination in any case, for any reason. The Commissioner ordinarily will not issue a determination to any taxpayer in either of the following circumstances.

1. The Commissioner ordinarily will not issue a determination if, at the time the application is made, the Department is investigating the taxpayer's nexus

with Massachusetts in connection with an audit or other examination.

2. The Commissioner ordinarily will not issue a determination if the taxpayer is currently filing corporate excise returns in Massachusetts.

(c) *Effect of Determination.* A nexus determination extends only to the facts stated in the corporation's request. The nexus determination is not an acknowledgment of the accuracy or completeness of this factual statement. The Commissioner reserves the right to investigate the accuracy and completeness of the corporation's factual statement, either before or after a determination is made. If, after a nexus determination is made, the Commissioner determines that a foreign corporation has engaged in any activities not fully disclosed in its request for a determination that constitute doing business in Massachusetts, the Commissioner may assess excise, including interest and penalties, for any taxable year, including the year for which the determination is issued, within the applicable statute of limitations. (Generally, no statute of limitations applies to periods for which a taxpayer has failed to file a return.)

A valid nexus determination will be binding on the Commissioner with respect to the taxable year for which it is made. A determination that a foreign corporation does not have nexus with Massachusetts will be binding with respect to subsequent taxable years only if there is no change in the controlling law

and only if the taxpayer files an affidavit, signed by an officer authorized to sign tax returns, stating that the taxpayer's Massachusetts activities have not changed from those described in its request for a determination. The affidavit must be filed annually by mailing on or before the last day of the first quarter of the taxpayer's taxable year to the address stated in 830 CMR 63.39.1(9)(a). A determination is automatically revoked if the affidavit is not timely filed. Notwithstanding any affidavit, however, the Commissioner may revoke or reverse a nexus determination prospectively at any time by giving written notice to the taxpayer.

(10) *Examples.* The following examples illustrate the provisions of 830 CMR 63.39.1. Except as stated in Example 7, below, the examples assume that the foreign corporations involved have not qualified to do business in Massachusetts.

Example 1(a). Abundant Acres, Inc., is a foreign corporation that operates as a real estate broker. Abundant Acres has no office or employees in Massachusetts, but it has registered with the Massachusetts Board of Registry for Real Estate Brokers and Salesmen, and it brokers the sale of Massachusetts real estate. Abundant Acres is subject to the excise under M.G.L. c.63, §39, because it is doing business in Massachusetts within the meaning of 830 CMR 63.39.1(4) and because its activities do not constitute solicitation of orders for the sale of tangible personal property. See 830 CMR 63.39.1(5).

Example 1(b). Alluvial Acres, Inc. (Alluvial) is a foreign corporation that is a registered Realtor/ Broker in another state. It is not registered as a real estate broker in Massachusetts, it maintains no offices or agents in Massachusetts, and it owns or leases no real property in Massachusetts.

For a fee, Alluvial will provide space in its computer database to real estate sellers to list their properties. Each property is included in listings compiled for distribution to potential buyers interested in property in the seller's area. Alluvial conducts business by mail or telephone. It solicits property listings through advertisements in national and regional publications. Alluvial does not act as a broker with respect to the sale of Massachusetts real estate. It plays no part in negotiations or settlements, receives no commissions, and has no contact with buyers and sellers other than collecting and distributing information.

Alluvial is not doing business or exercising its charter in Massachusetts. It does not own or use any property in the Commonwealth. It is not subject to the excise under M.G.L.c. 63, §39.

Example 2. Barefoot Builders, Inc. (Barefoot) is a foreign corporation engaged in the leasing of construction vehicles. Barefoot leases vehicles to individuals and businesses in Massachusetts. It has no offices or employees in Massachusetts. Nevertheless, Barefoot is subject to the corporate excise under M.G.L.c. 63, §39, because it owns

property located in Massachusetts and it does not use that property for "solicitation" within the meaning of 830 CMR 63.39.1(5).

Example 3. Convoluted Computers, Inc. (Convoluted) is a foreign corporation that manufactures mainframe computers and peripherals. Convoluted has no offices in Massachusetts. It employs sales representatives who visit Massachusetts periodically to solicit orders. These representatives give presentations explaining the capacities and advantages of Convoluted's computers. The representatives also provide general price information to prospective customers, but they have no authority to accept orders. Final contract negotiations and execution of contracts occur at Convoluted's home office outside of the Commonwealth. Convoluted ships its products to Massachusetts by common carrier.

In addition to its sales representatives, Convoluted also employs technicians who install and service the machines purchased by Massachusetts customers. The technicians are based at Convoluted's home office and travel to the customers facilities only for as long as the installation requires.

Because Convoluted employs workers in the Commonwealth, its activities fall within the scope of M.G.L. c. 63, §39, unless they are protected by P.L. 86-272. Convoluted's sales representatives engage in protected solicitation activities. However, Convoluted's technicians are providing services, not

soliciting sales of tangible property, so their activities are not protected. See 830 CMR 63.39.1(5)(b) and (5)(e). Since foreign corporations that engage in both protected and unprotected activities are subject to the Massachusetts corporate excise, Convoluted must file a return and pay the associated excise.

Example 4. Diffuse Deliveries, Inc. (Diffuse) is a foreign corporation engaged in interstate trucking. Diffuse's trucks frequently transport goods over the roads of Massachusetts, and may or may not pick up or deliver goods in the Commonwealth. Diffuse is subject to the Massachusetts corporate excise because it uses corporate property (trucks) and provides a service (transportation) in Massachusetts and because its activities are not solicitation of orders for the sale of tangible personal property.

Example 5. Eager Educators, Inc. (Eager) is a foreign corporation engaged in the business of conducting and marketing personal development training seminars. Eager either conducts seminars itself, using its own employees, or trains employees of client corporations to run seminars for those corporations. In either circumstance, Eager provides written course materials for each seminar participant. Eager has no offices in Massachusetts.

Eager provides its customers with a combination of services (training or instruction) and tangible property (course materials). Eager will therefore be subject to the Massachusetts corporate excise if it:

(a) conducts seminars in Massachusetts, using its own employees;

(b) contracts to allow one or more clients to conduct seminars in Massachusetts, and

1. the contract is executed in Massachusetts; or

2. Eager's employees come to Massachusetts to train, supervise, or advise client instructors, or to deliver course materials; or

(c) sends employees to trade shows or conventions in the Commonwealth or otherwise solicits sales of services in Massachusetts through sales personnel located in the Commonwealth.

Eager will not be doing business in Massachusetts and will not be subject to excise under M.G.L.c. 63, §39, if its activities in Massachusetts are limited to one or both of the following:

1. solicitation of business by telephone from outside of the Commonwealth; or

2. advertising in trade journals distributed in Massachusetts.

Example 6. Flirtatious Flavors, Inc. (Flirtatious) is a foreign corporation engaged in the manufacture and sale of candies. Flirtatious has no office or retail outlets in Massachusetts. However, it employs three full-time sales representatives who live in Massachusetts and who solicit sales in Massachusetts and other New England states. The sales representatives work out of their homes but do not

store inventory there, and do not publicize their home addresses as business addresses of Flirtatious.

Flirtatious provides each of its sales representatives with a company-owned car. The cars are registered and principally used in Massachusetts. They are garaged at the sales representatives' homes, and are used by the representatives to visit customers.

Flirtatious employs workers and maintains a limited quantity of corporate property (company cars) in Massachusetts. However, its activities, including the activities in which its property is used, are limited to the solicitation of orders for the sale of tangible personal property. See 830 CMR 63.39.1(5). Therefore, it is not subject to the Massachusetts corporate excise.

Example 7. Geronimo Gents, Inc. (Geronimo) is a foreign corporation engaged in the retail sale of designer parachutes and fashionable gentlemen's parachuting attire. In 1988, Geronimo qualified to do business in Massachusetts and opened stores in Fall River and Newton Upper Falls. After high initial sales, Geronimo's profits plunged, and Geronimo abandoned its local operations in 1989. However, despite ceasing Massachusetts business activities, Geronimo remained qualified to do business in the Commonwealth until 1991.

The corporate excise under M.G.L. c. 63, §39, is imposed not only when a corporation does business in Massachusetts, but also when it is qualified to do

business in the Commonwealth. See 830 CMR 63.39.1(4)(a). The qualification to do business is not "solicitation." See 830 CMR 63.39.1(5)(d)22. Geronimo is subject to the corporate excise through its 1991 taxable year.

Example 8. Humble Homes is a foreign corporation that sells furniture. The company regularly delivers furniture that it has sold to locations in Massachusetts using its own delivery trucks. The delivery trucks are corporate property that the company owns or uses in Massachusetts in a corporate capacity within the meaning of 830 CMR 63.39.1(4)(d). The delivery of goods does not constitute "solicitation" of orders. Humble Homes is therefore subject to the excise under M.G.L.c. 63, §39.

Example 9. Invisible Inc. is a foreign corporation that holds intangible assets. Invisible has no employees, tangible property, or sales. However, the majority of its corporate functions are performed in Massachusetts. These corporate functions include maintaining books and records, holding directors' meeting, and making day-to-day business decisions. The corporate functions are performed in Massachusetts by Invisible's directors or by employees of an affiliate. Invisible is subject to the excise under M.G.L. c. 63, §39.

Example 10. Just Javelins, Inc. (Javelins) is a foreign corporation that manufacturers sports equipment outside of Massachusetts. Javelins opens a securities account with a Massachusetts financial

institution. Kindred, Inc., and retains Kindred as a financial advisor. Under an agreement signed by the two companies, Kindred has the authority to invest Javelins' assets in various securities. Officers of Javelins visit Kindred's office in Massachusetts two or three times per year, for one or two days per visit, to review the performance of Javelins' securities portfolio and to discuss future investment plans. Javelins has no other contracts with Massachusetts. Javelins is not doing business in Massachusetts and is not subject to tax under M.G.L.c. 63, §39.

APPENDIX F

Mass.Gov

Department of Revenue

Directive 96-2: Creation of Nexus Through the In-State Ownership and Use of Intangible Property

Issue

Under what circumstances will the in-state ownership and use of intangible property subject a foreign corporation to the corporate excise?

Directive

A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise when:

1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise; and

2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and

3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimis.

Explanation

Under G.L. c. 63, § 39, a foreign corporation is subject to the corporate excise when, *inter alia*, it does business in Massachusetts, or owns or uses any part or all of its capital, plant, or any other property in the state. The Commissioner construes this provision to the full extent permitted by the Constitution and laws of the United States.

The definition of intangible property generally includes, but is not limited to, copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how. However, for purposes of this directive, the Commissioner will treat a license of canned software, transferred on a tangible medium to be used for any purpose other than commercial reproduction, as the sale of tangible personal property, not the license of intangible property.

A foreign corporation whose in-state activity is described in G.L. c. 63, § 39 is not subject to the Massachusetts corporate excise if such in-state activity is within the confines of Public Law 86-272 (15 U.S.C. § 381 et seq.). Public Law 86-272 precludes the imposition of a corporate tax measured by net income when a foreign corporation's sole activity in Massachusetts is solicitation of sales of tangible personal property, provided certain conditions are met. For example, Public Law 86-272 could potentially apply to a foreign corporation's solicitation of sales in Massachusetts of tangible personal property which contains intangible property (such as

books, recordings, or canned software). In contrast, the focus of this directive is transactions in which a foreign corporation derives gross receipts from intangible property that is licensed or otherwise transferred for continuing commercial exploitation in the state. These latter transactions are not protected by Public Law 86-272.

Examples

The following examples illustrate the application of this directive. In Examples 1-3, it is presumed that the foreign corporation's presence in Massachusetts, as indicated by its intangible property and its activities with respect to that property, is more than de minimis. Moreover, in Examples 1-3 it is presumed that the foreign corporation does not otherwise transact business or own property in the state.

Example 1

Dress Shop, a Delaware corporation located in Wisconsin, manufactures and sells girls' clothing under the name Tinker Bell. In Year 1, Dress Shop licenses the name Tinker Bell to Girl Towne, a Massachusetts company, for use in connection with the sale of clothing produced by Girl Towne in Massachusetts. Pursuant to the contract entered into between Dress Shop and Girl Towne, Girl Towne is to pay Dress Shop a royalty of 2% on the sale of every item of clothing sold under the Tinker Bell name. Girl Towne makes sales under the Tinker Bell

name in Massachusetts during Year 1 and makes the corresponding royalty payments to Dress Shop, as required. Dress Shop has nexus with Massachusetts in Year 1.

Example 2

Motor Way, a Delaware corporation located in Alabama, develops the technology for a new low-weight motor scooter and patents this technology. In Year 2, Motor Way licenses its patented technology to Speed Rider, a Massachusetts company, for use in connection with the manufacture and sale of scooters in Massachusetts. Pursuant to the contract entered into between Motor Way and Speed Rider, Speed Rider is to pay Motor Way an upfront fee for the right to make use of Motor Way's patented technology, and a royalty of 4% on the sale of every scooter that Speed Rider manufactures and sells using this technology. Speed Rider manufactures scooters using the Motor Way technology in Year 2, and sells these scooters in Massachusetts during that same year. In addition, Speed Rider makes the corresponding royalty payments to Motor Way for Year 2, as required. Motor Way has nexus with Massachusetts in Year 2.

Example 3

Ginzu Ltd. is a fast-food franchiser, incorporated in Delaware and located in New Jersey. In Year 3, Ginzu Ltd. franchises the rights to one of its "Ginzu Gardens" fast-food restaurants to a franchisee, John

Cook, a New Hampshire resident, for a location in Massachusetts. The terms of the franchise agreement both permit and require Mr. Cook to use the various items of intangible property owned by Ginzu Ltd. (e.g., the name "Ginzu Gardens," certain service marks, a patented food process, trade secrets, and know-how). In addition, the terms of the franchise agreement require Mr. Cook to pay Ginzu Ltd. a monthly franchise fee, as well as a royalty charge of 6% of the sales proceeds received by the Massachusetts' restaurant, Ginzu Gardens. Mr. Cook makes such payments to Ginzu Ltd. during Year 3, as required. Ginzu Ltd. has nexus with Massachusetts in Year 3.

Example 4

Golf Time is a corporation, incorporated in South Carolina and located there. Golf Time is the creator of "cold day" golf clubs. "Cold day" golf clubs have grips that emit warmth when squeezed, since they are specially treated with Golf Time's "heat-grip" technology. Golf Time has patented its "heat grip" technology, and obtained registered trademarks for each of the terms "cold day" and "heat-grip." Golf Time solicits sales of its "cold day" golf clubs in Massachusetts, touting the merits of its "heat grip" technology. Golf Time's activities result in significant sales of "cold day" golf clubs in Massachusetts. Golf Time engages in no other business activity with respect to Massachusetts. Assuming Golf Time's Massachusetts activities are protected by Public Law

86-272, Golf Time will not be subject to the corporate excise for the years in question.

Effective Date

The principles set forth in this directive will apply to taxable years beginning on or after January 1, 1996.

Frederick A. Laskey
Senior Deputy Commissioner

July 3, 1996

APPENDIX G

GEOFFREY, INC. V. MASSACHUSETTS COMMISSIONER OF REVENUE OPINION OF PROFESSOR RICHARD D. POMP[1]

(Entered Into Evidence Sept. 27, 2005, Before The Mass. App. Tax Board, *see* Record 714-720, 811)

I. INTRODUCTION

You have contacted me as the former Director of the New York Tax Study Commission and as someone who, for 30 years, has studied, lectured, taught, published, and consulted with, and testified on behalf of, state and local governments regarding issues of state taxation. I have served as a consultant to Alaska, California, Connecticut, Delaware, Hartford, Illinois, Louisiana, Montana, New Jersey, New Mexico, New York, North Dakota, San Francisco, South Carolina, Tennessee, Texas, Utah, West Virginia, and the Multistate Tax Commission. I have also served as a consultant to the Internal Revenue Service, the Department of Justice, the U.S. Congress, the International Monetary Fund, the World Bank, the United Nations, and numerous foreign countries.

I have been qualified as an expert witness in California, Colorado, Connecticut, Delaware, Illinois, Kansas, Louisiana, Massachusetts, Michigan,

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[1] Alva P. Loiselle Professor of Law, Connecticut Law School; Adjunct Professor of Law, NYU Law School (LL.M. Program in Taxation); Adjunct Professor of Law, Columbia Law School.

Montana, New Jersey, New York, New York City, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, and West Virginia. About half of these appearances have been on behalf of the states.

Further details are contained in the attached curriculum vitae.

II. OVERVIEW

Geoffrey, Inc. (Appellant) is a Delaware corporation. During the audit years at issue (taxable years ending January 31, 1997 through January 31, 2001), Appellant had its principal place of business first in Delaware and then in New Jersey.

Appellant was incorporated in 1984. In that year, Toys R Us, Inc. transferred trademarks, trade names, and service marks ("Trademarks") to Appellant, including the Toys R Us and Kids R Us trademarks in exchange for stock. Subsequently, Appellant licensed Toys R Us, Inc. to use the Trademarks in all states except New York, Texas, Pennsylvania, Massachusetts, and New Jersey. Appellant entered into a separate license agreement with Toys R Us-Mass., Inc. (TRUMI), under which TRUMI was allowed to use the Trademarks solely in Massachusetts. Appellant received a 2% royalty of TRUMI's net sales at Kids R Us stores in Massachusetts for the use of the Kids R Us trademarks and a royalty of 3% of TRUMI's net sales at Toys R Us in Massachusetts for the use of the Toys R Us trademarks. The royalties were set

pursuant to a third-party transfer pricing study. Appellant also entered into license agreements with other Toys R Us, Inc. affiliates and unrelated entities.

Appellant had no office, tangible personal property, employees, or agents in Massachusetts.

Massachusetts General Law Ch. 63, Sec. 19 provides in relevant part that:

"[E]very foreign corporation . . . actually doing business in the commonwealth, or owning or using any part or all of its . . . property in the commonwealth, shall pay [the corporation excise tax].

Department of Revenue Directive 96-2 (July 3, 1996) provides that:

"A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise when:

1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise; and

2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and

3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than de minimis."

The Commissioner views the Appellant has having had nexus with Massachusetts because of its license agreement with TRUMI. The Commissioner is asserting a concept of nexus known as economic presence. In contrast, Appellant asserts that because it has no physical presence in Massachusetts it has no nexus. In other words, this case presents a clash between two competing theories of nexus.

You have asked me to discuss from a policy perspective these opposite theories and evaluate them in terms of normative principles. You have asked me not to discuss Massachusetts law or constitutional law.

III. ANALYSIS

Policy Evaluation of Physical and Economic Presence

I evaluate these competing theories, of nexus by asking which is: (1) more consistent with a bright line test; (2) more consistent with settled expectations; (3) more likely to reduce litigation and foster interstate investment; (4) less likely to discriminate against the financial sector; (5) less likely to lead to multiple taxation of national issuers of credit cards; and (6) more likely to be fairly or easily administered.

For the reasons explained below, I conclude that physical presence is clearly superior to economic presence as a nexus standard when measured against any of these criteria.

1. Physical presence is more consistent with a bright line test

A bright line test is especially needed when the issue is nexus. A nexus standard operates in a stark, all or nothing fashion: a company will either be subject to an income-based tax or it will not. The need for a bright line test is especially acute where millions of dollars of income-based taxes can turn on whether nexus exists.

From this policy perspective, an overwhelming virtue of the physical presence standard is that it provides a bright line test. People or tangible property are visible and can be identified through physical observation. Their existence and presence is unambiguous; people or property are either in a state or they or not.

In sharp contrast, economic presence is an amorphous concept, having no crisp edges. Economic presence can be defined in various ways, using various indicia of "presence." One measure of economic presence is intangible property, such as the license and use of trademarks. The essence of intangible property, however, is that it lacks any inherent utilitarian value but merely represents a set of legal rights and obligations. As the dictionary recognizes, intangible

property "cannot be easily defined, formulated, or grasped."[2]

Unlike persons or tangible property that can be identified geographically, intangible property cannot be located in any particular state except through legal fictions or doctrines. One legal fiction includes the doctrine of mobilia sequuntur personam, which would treat a licensing agreement as being attached to the person that owns it. Another approach creates the fiction that an intangible has a business situs but there are different rules to identify that situs.

The problem that arises with all of these legal fictions is that they do not produce a unique solution to where an intangible is located. For example, under the doctrine of mobilia sequuntur personam, the state of legal domicile could take the position that the license agreement was located there. The state of commercial domicile could take the position that it was the location of the agreement. The state where the royalties were generated could take the view that the license agreement was located there.

Compared with a physical presence standard, economic presence not only provides no bright line rule, but also provides no determinate or unique answer to the nexus question. A rule that can locate an intangible simultaneously in more than one state

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[2] Webster's New Universal Unabridged Dictionary (Deluxe 2nd ed.).

is not a principle of nexus but rather an invitation to chaos.

2. Physical presence is more consistent with settled expectations

There is no U.S. Supreme Court case holding that economic presence satisfies commerce clause nexus. All of the U.S. Supreme Court cases dealing with commerce clause nexus for corporate income tax purposes involved corporations that had a physical presence. Indeed, taxpayers have been very careful in structuring their activities to avoid having a physical presence in those states in which they did not wish to have nexus. In my opinion, the expectation of corporate taxpayers is that no nexus exists under the commerce clause without physical presence.

The economic presence rule is obviously inconsistent with this expectation. If this expectation is to be frustrated by the imposition of a new, economic presence rule, Congress is the only appropriate body to do so. Corporations relying on the physical presence standard, such as the issuers of credit cards, have not filed income tax returns on the justifiable assumption that nexus did not exist. Without the filing of a return, the statute of limitations does not run in most states and localities. Consequently, enormous retroactive exposure exists if a new nexus standard is adopted by a jurisdiction. Congress is the ideal body to balance the interests of the various

parties should it decide that the nexus standard should be changed.

3. Physical presence is more likely to reduce litigation and foster interstate investment

The physical presence nexus standard has the weight of history and tradition behind it. It has been litigated over the years and its boundaries are well known and accepted. It provides a knowable and determinable standard. Rules have grown up around this standard that minimize multiple taxation and reduce the likelihood that interstate commerce will be unduly burdened. Long-standing precedent supports the standard, which furthers the stability and orderly development of the law. A long-standing doctrine like that of physical presence offers the kind of stability and predictability that fosters interstate investment.

Economic presence invites years of litigation. The very fact that intangible property, such as the rights represented by a credit card, does not physically exist in the way that tangible property or persons exist is an invitation to endless litigation and chaos. Economic presence cannot be expected to have the same crisp, sharp edges as a concept as does physical presence, even after years of litigation. The uncertainty and cloud over the concept of economic nexus can only discourage certain types of interstate investment and thereby thwart the goals of the commerce clause.

4. Economic presence discriminates against the service sector, such as the issuers of credit cards

The physical presence nexus standard has helped maintain tax parity between the service and financial sector, and the manufacturing and mercantile sectors of the economy. The manufacturing and mercantile sectors have been the beneficiaries of a special federal nexus statute: Public Law 86-272. The physical presence nexus standard complements Public Law 86-272 in a very significant way that helps maintain a level playing field between the manufacturing and mercantile sectors and the service sector and financial sectors.

Specifically, Public Law 86-272 provides a federal nexus standard by preventing a state from taxing the income of a corporation whose only business activities within the state consist of the solicitation of orders for *tangible personal property*. Public Law 86-272 is limited to tangible personal property and does not extend to services, such as financial services. This limitation is presumably explained by two factors. First, the law was enacted in order to overrule *Northwestern Portland Cement*,[3] which upheld the imposition of a tax on the income of a purely interstate taxpayer selling tangible property – not services.

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[3] 358 U.S. 450 (1959).

Second, the law was adopted in 1959, at a time when the service and financial sectors was greatly overshadowed by the manufacturing and mercantile sectors. Further, the service sector tended to be intrastate in nature and not interstate. Accordingly, when Public Law 86-272 was adopted, Congress was focusing on the sale of tangible personal property and not on the relatively insignificant interstate service or financial sectors.

As interstate services grew in importance and significance and were deregulated, the physical presence rule allowed these sectors to achieve similar protection to that extended to the manufacturing and mercantile sectors under Public Law 86-272. Physical presence nexus is to the service and financial sectors what Public Law 86-272 is to the manufacturing and mercantile sectors.

The understanding and expectation of the service sector is that as long as they earn income in a state without having people or property in that state, no commerce clause nexus exists and no income tax can be imposed. The requirement of physical presence thus allows the financial and service sectors to achieve nearly the same treatment as those taxpayers that are protected by Public Law 86-272. Accordingly, the physical presence standard helps maintain competitive equity between taxpayers that provide services and those competitors that provide tangible personal property.

An economic presence rule would upset this balance and accommodation. Economic presence would exaggerate, rather than reduce, the competitive inequities of Public Law 86-272. The result would be to move away from a level playing field and discriminate against service providers, thus interfering unfairly and inequitably with the most rapidly growing sector in the U.S. economy.

5. Economic presence is more likely to lead to multiple taxation

As discussed above, intangible property has no corporeal form and does not physically exist. Consequently, unlike people or tangible property, intangible property cannot be physically located in any particular state through physical observation. Intangible property can be located in a state only through arbitrary rules that can vary from state to state. As illustrated above, the state of commercial domicile, the state of legal domicile, and the state of business situs might all seek to tax the royalties generated by a license agreement.

Consider a corporation that licenses the use of a trademark from L, the licensor. L is incorporated in State I and has its commercial domicile in State C. The corporation agrees to pay a royalty for every good it manufactures and sells bearing L's trademark. Assume the taxpayer manufactures the goods in State M, and sells the goods in State S.

Suppose that M considers the license to be located in the state of manufacture, that State S considers the license to be located in the state in which the goods are sold, that State C considers the license to be located at the licensor's commercial domicile, and that State I considers the license to be located at the licensor's state of incorporation. Under an economic presence standard, L – the licensor – would have nexus with States M, S, and C. The same royalty payment would be taxed by each of these states, resulting in multiple taxation.

6. Economic presence cannot be easily or fairly administered as a nexus standard

Economic nexus presents formidable administrative problems. An author receiving royalties from the sale of a book could be taxable in every state in which the book was sold. A television producer receiving royalties by a network for the use of a program could be taxable in every state in which the program was televised. An electronic data bank receiving payments for the use of its services could be taxable in every state in which its logo appeared on a computer screen. A start up company in Silicon Valley could be subject to tax in every state in which its software licensees operate. A bank purchasing mortgages could be subject to tax in every state in which the underlying mortgagors reside or in which the collateral were located. An athlete receiving royalties from the endorsement of a product could be taxable in every state in which the product was sold. A remote

vendor with modest sales in each of the fifty states would be required to file returns everywhere.

As these examples suggest, the compliance burdens for taxpayers and administrators would be immense under an economic presence rule. Small and medium sized businesses would be saddled with the obligation to comply with the tax laws of states with which they would have no familiarity. Administrative considerations alone suggest that economic presence is incompatible with the values and goals of the commerce clause.

III. CONCLUSION

By any principled measure of comparison, physical presence is to be preferred to economic presence as a nexus standard. Physical presence is more consistent with a bright line test, more consistent with settled expectations, more likely to reduce litigation and foster interstate investment, less likely to discriminate against the service sector, less likely to lead to multiple taxation, more easily administered, and more compatible with the growth of electronic commerce.

The states have little experience with administering an economic presence standard; the concept is amorphous and easily malleable. Economic presence is less a legal principle and more an invitation to chaos and multiple taxation.

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No. 08-1207

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OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE
SUPREME COURT OF THE UNITED STATES

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME JUDICIAL COURT OF MASSACHUSETTS

BRIEF IN OPPOSITION

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QUESTION PRESENTED

A corporation licenses intangible property such as trademarks to an affiliated corporation for use by the affiliate within Massachusetts. The licensing corporation receives income from the licensee and concedes that it is "doing business" in Massachusetts and is therefore subject under state law to the corporate net income tax, a tax conceded by the taxpayer to be fairly apportioned, non-discriminatory, and fairly related to the services provided by the State. The question presented is whether the activity of the taxpayer has a "substantial nexus" with Massachusetts, as required by the Commerce Clause for the assessment of such a tax on a corporation engaged in interstate commerce, despite the fact that the taxpayer has no tangible property in the taxing State.

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INTRODUCTION

Pursuant to Supreme Court Rule 15, respondent Commissioner of Revenue of Massachusetts submits this brief in opposition to the petition for a writ of certiorari. The writ should be denied because (1) the decision of the Massachusetts Supreme Judicial Court ("SJC") is consistent with the decisions of this Court and the requirement that a state tax be applied to "an activity with a substantial nexus with the taxing State"; (2) the decision of the SJC enlarges a growing consensus of the States' highest courts rejecting the claim that the Commerce Clause requires a "physical presence" in order to establish a "substantial nexus"; (3) the Court should not grant review based on mere speculation about burdens on interstate and foreign commerce; and (4) the Court should deny review in deference to the constitutional role of Congress in weighing burdens on interstate commerce.

OPINIONS BELOW, JURISDICTION, AND CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Respondent accepts petitioner's citations to the opinions below and the constitutional and statutory provisions involved. Regarding the jurisdiction of the Court, respondent notes that the sole provision invoked by the petitioner, 28 U.S.C. § 1254(1), does not authorize review by this Court of a judgment of a state court.

STATEMENT

The Mass. Corporate Excise Tax

The respondent is the state official authorized to enforce the tax laws of Massachusetts. Mass. Gen. Laws ch. 14, §§ 1-3; ch. 62C, § 3. Among her duties is the enforcement of the corporate excise tax imposed on domestic and out-of-state corporations doing business in the Commonwealth. *See* Mass. Gen. Laws ch. 63, § 39 (foreign corporations). During the relevant years, Mass. Gen. Laws ch. 63, § 30, defined "foreign corporations" as:

> a corporation, association or organization established, organized or chartered under laws other than those of the commonwealth, for purposes for which domestic corporations may be organized . . . which has privileges, powers, rights or immunities not possessed by individuals or partnerships . . . .

Mass. Gen. Laws ch. 63, § 30(2) (1996 ed.). Chapter 63, § 39 provided in part:

> Except as otherwise provided herein, *every foreign corporation*, exercising its charter, or qualified to do business or *actually doing business in the commonwealth, or owning or using any part or all of its capital, plant or any other property in the commonwealth, shall pay*, on account of each taxable year, *the*

excise provided in subsection (a) or (b) of this section, whichever is greater.

The excise levied herein is due and payable on any one or all of the following alternative incidents:

(1) The qualification to carry on or do business in this state or *the actual doing of business* within the commonwealth in a corporate form. The term "doing business" as used herein shall mean and include each and every act, power, right, privilege, or immunity exercised or enjoyed in the commonwealth, as an incident to or by virtue of the powers and privileges acquired by the nature of such organizations, as well as, the buying, selling or procuring of services or property.

(2) The exercising of a corporation's charter or the continuance of its charter within the commonwealth.

(3) *The owning or using any part or all of its capital, plant or other property in the commonwealth in a corporate capacity.*

It is the purpose of this section to require the payment of this excise to the commonwealth by foreign corporations for the enjoyment under the protection of the laws of the Commonwealth, of the powers, rights, privileges and immunities derived by reason

> *of the corporate form of existence and operation.*
>
> . . .

Mass. Gen. Laws ch. 63, § 39 (1996 ed.)(emphasis added).

The Commissioner has the power under Mass. Gen. Laws ch. 14, § 6(1) to "make . . . and from time to time . . . revise . . . such reasonable regulations . . . as may be necessary to interpret any statute imposing any tax, excise or fee." One year after the decision of this Court in *Quill v. North Dakota*, 504 U.S. 298 (1992), the Commissioner promulgated 830 Code of Mass. Regs. (C.M.R.) § 63.39.1 to "describe[] the circumstances under which a foreign corporation is subject to the tax jurisdiction of Massachusetts under [Mass. Gen. Laws ch.] 63, § 39." 830 C.M.R. § 63.39.1(1)(a). App. 92a. Title 830 C.M.R. § 63.39.1(4) and (4)(d)(1) provide that "a foreign corporation must file a return in Massachusetts and pay the associated tax if . . . the corporation owns property that is held by another in Massachusetts under a lease, consignment, or other arrangement." App. 96a-97a; *see* 3 *MassTaxGuide--Corporate Excise* (Thomson West, 2007) at R-244 (setting forth history of relevant regulatory authority).

Specifically addressing intangible property, the Commissioner in 1996 issued Directive 96-2. *Id.* at PWS-214-16, App. 125a-130a. Directive 96-2 states the Commissioner's position regarding the application of the corporate excise to the ownership

and use of intangible property in the Commonwealth. The Directive states:

> A foreign corporation's intangible property used within Massachusetts will subject that corporation to the corporate excise when:
>
> 1. The intangible property generates, or is otherwise a source of, gross receipts within the state for the corporation, including through a license or franchise;
>
> 2. The activity through which the corporation obtains such gross receipts from its intangible property is purposeful (e.g., a contract with an in-state company); and
>
> 3. The corporation's presence within the state, as indicated by its intangible property and its activities with respect to that property, is more than *de minimis*.

App. 125a-126a. Directive 96-2 further states that "the definition of intangible property generally includes, but is not limited to, copyrights, patents, trademarks, trade names, trade secrets, service marks, and know-how." App. 126a.

A finding of constitutional "nexus" between the activities of an out-of-state corporation and Massachusetts does not subject all of the

corporation's net income to tax by the Commonwealth. A foreign corporation doing business within and without Massachusetts and subject to tax under § 39 may apportion its income among the States and thereby reduce its net income subject to tax in each State under the formula set forth in Mass. Gen. Laws ch. 63, § 38. Taxable net income is determined by taking the corporation's Federal net income, as defined in Mass. Gen. Laws ch. 63, § 30, applying statutory deductions enumerated in Mass. Gen. Laws ch. 63, § 38(a), and multiplying the result by the three-factor apportionment formula in G.L. c. 63, § 38(c). The apportionment formula is the "weighted average of three factors---property, payroll, and sales---commonly used to compare the value of business conducted within and without [Massachusetts]." *Gillette Co. v. Commissioner of Revenue*, 683 N.E.2d 270, 273 (Mass. 1997). "Each factor is a fraction in itself, the numerator of which is the local corporate property, payroll, or sales; the denominator of which is the corporation's total property, payroll, or sales 'everywhere' during the taxable year." *Id.*

Proceedings before the Commissioner of Revenue, the Appellate Tax Board, and the Supreme Judicial Court

Geoffrey failed to file tax returns under Mass. Gen. Laws c. 63, § 39 for the taxable years ending January 31, 1997 through January 31, 2001 for royalty income earned from its affiliate in Massachusetts for the use of Geoffrey's intangible property there. App. 7a, 24a. The Commissioner

assessed Geoffrey for taxes for the years at issue in the amount of approximately $ 3.1 million. App. 7a. Geoffrey sought an abatement of the tax. App. 7a, 25a. The Commissioner denied the application for abatement. App. 7a-8a.

Geoffrey appealed to the Massachusetts Appellate Tax Board (the "Board"). App. 8a, 25a. The Board affirmed the Commissioner. App. 8a, 40a-46a. The Board rejected the claim that the Commerce Clause requires the physical presence of the taxpayer in order to assess a net income or franchise tax. App. 40a. Relying on its decision in *Capital One Bank v. Comm'r of Revenue*, ATB Nos. C262391, C262598, 2007 WL 1810723 (Mass. App. Tax Board June 22, 2007), *aff'd*, 453 Mass. 1 (2008), *petition for cert. filed*, United States Supreme Court No. 08-1169, and several similar decisions involving Geoffrey and issued by other state courts, the Board ruled that there is no such requirement for such a state corporate excise tax under the Commerce Clause. App. 8a, 40a-46a. Turning to Geoffrey's presence in Massachusetts, the Board found that Geoffrey had "derived substantial economic gain" from the use of its property in the Commonwealth. App. 43a-44a. The Board found that the "good will represented by Geoffrey's Trademarks, which was carefully guarded, and the assurance of product quality they were intended to give, enabled transactions to occur in Massachusetts from which Geoffrey obtained substantial royalty income." App. 44a. The Board accordingly found that the "substantial nexus" required by the Commerce

Clause "was satisfied by" Geoffrey's "economic presence in Massachusetts." *Id.*

Geoffrey appealed the decision of the Board to the Massachusetts Appeals Court. App. 19a. The Supreme Judicial Court granted direct appellate review and affirmed. App. 1a, 2a, 19a. The SJC held that "substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer." App. 11a. Relying on facts set forth in the next section of this brief, the SJC further concluded that "Geoffrey's activities established a substantial nexus with Massachusetts." App. 13a.

Facts Concerning Geoffrey's
Activities in Massachusetts

Pursuant to Supreme Court Rule 15, the respondent supplements petitioner's statement of the case with the following facts drawn from the decisions of the Board and the SJC.

Geoffrey was formed in 1984, as a wholly-owned subsidiary of Toys "R" Us, Inc. ("Toys Inc."). App. 3a-4a, 26a. Toys Inc. later transferred trademarks, trade names, and service marks to Geoffrey in exchange for stock. App. 4a, 26a. Among the transferred intellectual property were the "Toys 'R' Us" and "Kids 'R' Us" trademarks and the "Geoffrey" giraffe character logo. *Id.* A 1991 appraisal by Arthur Andersen & Co. placed the fair

market value of Geoffrey's intellectual property at $1.5 billion. App. 4a, 26a-27a.

During the years at issue, Geoffrey's entire business consisted of licensing its intellectual property to various Toys Inc. operating companies to use in furtherance of their retail operations. App. 4a, 27a. One such company was Toys "R" Us-Mass, Inc. ("TRUMI"), another wholly owned subsidiary of Toys Inc. App. 4a, 26a. During the years at issue, TRUMI operated twenty-six Toys "R" Us retail toy stores and Kids "R" Us retail children's clothing stores in Massachusetts. *Id.*. Pursuant to a license agreement dated May 3, 1992, Geoffrey licensed its intellectual property to TRUMI for use exclusively in Massachusetts in exchange for royalty payments to Geoffrey at a rate of three percent of TRUMI's net sales income at its Toys "R" Us stores, and two percent of its net sales income at its Kids "R" Us stores. App. 4a, 27a.

In February 1997, Geoffrey entered into a similar licensing agreement with Babies "R" Us, Inc. for the use of Geoffrey's "Babies 'R' Us" trademark. App. 5a, 28a. Babies "R" Us is a division of Baby Superstore, Inc., which is an affiliate of TRUMI. *Id.* During the years at issue, Babies "R" Us, Inc. operated three retail stores in Massachusetts. *Id.* Under the licensing agreement, Babies "R" Us, Inc. paid Geoffrey a royalty rate of one percent of net sales income for the fiscal year 1996, one and one half percent of net sales income for the fiscal year 1997, and two percent of net sales income for the duration of the agreement. *Id.*

Geoffrey derived over $33 million in royalties from the Massachusetts consumer marketplace during the years at issue. App 6a. Geoffrey's trademarks appeared on signage, store displays, and product packaging at Massachusetts Toys "R" Us, Kids "R" Us, and Babies "R" Us retail stores. *Id.*

Geoffrey also depended on quality control to protect its intellectual property and to maximize its royalty income. App. 5a-6a, 29a. Pursuant to the license agreements with TRUMI and Babies "R" Us, Geoffrey retained the right to preview and disapprove product samples and specifications, signs, labels, tags, packaging material, advertising and sales promotion materials, bills, catalogs, and pamphlets which displayed any of its intellectual property. App. 5a-6a, 29a. Geoffrey's royalty income of $33 million was dependent on both the appearance and the display of the intellectual property as well as the proper operations and cleanliness of the retail stores. App. 5a-6a, 29a-30a.

Finally, Geoffrey had access to both Massachusetts courts and federal courts located in Massachusetts, to protect its intellectual property and its right to royalty payments under the licensing agreements. App. 8a, 32a.

REASONS FOR DENYING THE WRIT

I. THE DECISION OF THE SJC IS CONSISTENT WITH *QUILL* AND THE REQUIREMENT IN *COMPLETE AUTO* THAT A STATE TAX BE APPLIED TO "AN ACTIVITY WITH A SUBSTANTIAL NEXUS WITH THE TAXING STATE."

A. The Decision of the SJC Is Consistent with *Quill*'s Express Limitation to Sales and Use Taxes.

Under the Commerce Clause, a State may tax a company engaged in purely interstate commerce provided that the tax is "[1] applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). In permitting the States to tax purely interstate commerce, *Complete Auto* overruled *Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951)(striking down a Missouri tax on an interstate trucking company). *Id.* *Complete Auto* thus reaffirmed the principle that "interstate commerce may be made to pay its own way." *Id.* at 288-89 n.15.

Here, petitioner concedes that the tax is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State. It challenges the tax only under the "substantial nexus" test.

The Court applied the substantial nexus test to the collection of a use tax in *Quill*. A use tax is typically imposed on the storage, use, or consumption of goods or services purchased outside the taxing State for storage, use, or consumption within the taxing State. *See* Mass. Gen. Laws ch. 64I, § 2. The company in *Quill* was an out-of-state mail order house that had no affiliates or representatives, and only *de minimis* tangible or intangible property in the taxing State. The only connection between the company and its customers in the taxing State was "by common carrier or the United States mail." *Quill*, 504 U.S. at 301 (quotation omitted). The Supreme Court of North Dakota had declined to follow *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753, 758 (1967)—another mail-order sales and use tax case—on the ground that the holding was "obsolete." *Id.* Although this Court in *Quill* agreed "with much of the state court's reasoning" and held that the tax satisfied due process, it reversed the state-court judgment, reaffirmed *National Bellas Hess*, and held that the lack of a physical presence by the taxpayer demonstrated a lack of "substantial nexus" under the Commerce Clause. *Id.*

The rule maintained in *Quill*, however, is not controlling here. In preserving the *National Bellas Hess* rule for sales and use taxes, this Court relied heavily on the principle of *stare decisis*. *Id.* at 311, 317-18. The Court observed that "contemporary Commerce Clause jurisprudence might not dictate the same result were the issue to arise for the first

time today." *Id.* at 311, 318. The Court also relied on factors specific to sales and use taxation and the mail-order industry: the Court stated that the rule in *National Bellas Hess* had "engendered substantial reliance and has become part of the basic framework of a sizable industry." *Id.* at 317. Relying on these factors, *Quill* reaffirmed that substantial nexus for a *sales or use tax collection duty* requires the physical presence of the taxpayer in the taxing State, *id.* at 316-17, but carefully noted that it "has not, in [its] review of other types of taxes, articulated the same physical-presence requirement . . . ." *Id.* at 314; *see id.* at 317 ("concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement"). Justice Scalia's concurring opinion, which was joined by Justices Kennedy and Thomas, relied even more heavily on *stare decisis*. *Id.* at 320. Given the Court's express limitation of its holding, and the Court's substantial reliance on the principle of *stare decisis*, there is no basis for the claim that the decision below is in conflict with *Quill*.

B. The Fact-Specific Ruling Below Is Consistent with *Complete Auto* Because the Petitioners' Activities Have a Substantial Nexus with Massachusetts.

The SJC correctly adhered to the Court's express limitation of *Quill* to sales and use taxes and applied the *Complete Auto* test without imposing a threshold requirement that petitioner have a physical presence in Massachusetts. App. 11a. *Complete Auto*'s substantive focus on "activities"

readily supports that judgment, given the petitioner's commercial contacts with Massachusetts and the use of its intangible property there, as detailed by the SJC. App. 13a.

The decision below thus represents a straightforward application of *Complete Auto*'s substantive focus on "activities." In the absence of a governing precedent like *Bellas Hess,* there is no warrant to transform the *Complete Auto* nexus test to demand physical presence as the *sine qua non* of corporate income taxation. Under petitioner's theory, a business owning and leasing to another a storefront in Massachusetts, and generating $100,000 of revenue from the lease, would have physical presence in Massachusetts and thus be subject to taxation. Yet a firm such as the petitioner, receiving millions of dollars of revenue from royalty payments from firms licensed to use its intangible property in Massachusetts, would be immune from a fairly apportioned, non-discriminatory corporate excise tax. This result is not compelled by *stare decisis*, as in *Quill* (in light of *Bellas Hess*). Indeed, it conflicts with the focus on substance required by *Complete Auto*, which generally requires that interstate commerce "pay its own way." *Id.* at 288-89 n.15. The decision of the SJC is fully consistent with *Complete Auto* and does not warrant review by this Court.

II. RATHER THAN CREATING A CONFLICT AMONG STATE COURTS, THE DECISION OF THE SJC ENLARGES A GROWING CONSENSUS OF THE STATES' HIGHEST COURTS REJECTING THE CLAIM THAT THE COMMERCE CLAUSE REQUIRES A "PHYSICAL PRESENCE" IN ORDER TO ESTABLISH A "SUBSTANTIAL NEXUS."

In determining whether to grant certiorari, the Court generally requires that a conflict of decisions be "real and embarrassing." *Rice v. Sioux City Cemetery*, 349 U.S. 70, 79 (1955) (quotation omitted). In this case, there is no conflict of sufficient degree or type. The overwhelming majority of state courts that have addressed the issue since the decision in *Quill* in 1992 have held that a physical presence is not required for a State to impose a fairly apportioned, non-discriminatory net income tax on corporations doing business in the taxing State. No state supreme court has held otherwise. Petitioner claims that there "is a mature, well-recognized, and entrenched split of authority among the state courts on the question" presented. Pet. 16. However, the three intermediate appellate court decisions cited by the petitioner are all at least nine years old and do not establish a current and significant conflict of state authority. In fact, any conflict of state decisions, if it had ever reached maturity, is now well past its shelf life.

A year after the decision in *Quill*, the South Carolina Supreme Court upheld an income-based tax

under the Commerce Clause, ruling that substantial nexus was created by the use of the taxpayer's trademarks within the taxing State. *See Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C.), *cert. denied*, 510 U.S. 992 (1993). The court held that "by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a 'substantial nexus' with South Carolina." *Id.* In the seventeen years after *Quill*, the clear majority of the state courts that have addressed the issue have similarly declined to apply a physical presence requirement to an income-based tax, in many cases brought by the petitioner here and involving the licensing of intangible property. *See Geoffrey, Inc. v. Okla. Tax Comm'n*, 132 P.3d 632, 638 (Okla. Civ. App. Ct. 2006)(trademark licensing); *Lanco, Inc. v. Dir., Div. of Taxation*, 908 A.2d 176, 177 (N.J. 2006), *cert. denied*, 127 S.Ct. 2974 (2007)(same); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 195 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005)(same); *Kmart Props., Inc. v. Taxation and Revenue Dep't*, 131 P.3d 27 (N.M. Ct. App. 2001), *cert. granted*, 40 P.3d 1008 (N.M. 2002), *cert. quashed*, 131 P.3d 22 (N.M. 2005) (same); *Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008) (same); *Secretary, Dep't of Revenue v. Gap (Apparel), Inc.*, 886 So.2d 459, 462 (La. Ct. App. 2004) (same); *Comptroller of the Treasury v. SYL, Inc.*, 825 A.2d 399 (Md. 2003)(same); *see also General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001); *Couchot v. State Lottery Comm'n*, 659 N.E.2d 1225, 1230 (Ohio 1996)("no indication in *Quill* that the Supreme Court will extend the physical presence requirement to

cases involving taxation measured by income derived from the state"); *Borden Chems. & Plastics v. Zehnder*, 726 N.E.2d 73, 80 (Ill. App. Ct. 2000)("Plaintiff argues that in *Quill*, the Supreme Court 'left open' the question of whether a physical presence is required in order to satisfy the substantial nexus requirement in other tax cases. We disagree."); *Buehner Block Co. v. Wyoming Dep't of Revenue*, 139 P.3d 1150, 1158 n.6 (Wyo. 2006) (*Bellas Hess* and *Quill* "created [a] specialized jurisprudence" applicable to "sales and use tax case[s]").

In similar cases involving out-of-state credit card companies, the two state supreme court decisions on point agree. *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), *petition for cert. filed*, (U.S. March 18, 2009) (No. 08-1169); *Tax Comm'r of W. Va. v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied sub nom. FIA Card Services, N.A. v. Tax Comm'r of W. Va.*, 127 S.Ct. 2997 (2007). *MBNA Am. Bank* held that (1) *Quill* was "grounded primarily on *stare decisis*, (2) the Court "appears to have expressly limited *Quill*'s scope to sales and use taxes," and (3) "franchise and income taxes . . . do not appear to cause the same degree of compliance burdens." *Id.* at 232-33; *see also MBNA Am. Bank, N.A. v. Ind. Dep't of State Revenue*, 895 N.E.2d 140 (Ind. Tax Ct. 2008) (citing West Virginia *MBNA Am. Bank* decision and rejecting requirement of physical presence).

Petitioner claims that the "decision below conflicts directly with the state appellate court rulings in Tennessee, Michigan, and Texas," but tells only part of the story. Pet. 16. These older decisions by state intermediate appellate courts[1] do not establish a conflict of authority that is worthy of review.

Only one of the three decisions cited by the petitioner strikes a State's franchise or income tax because of a lack of physical presence by the taxpayer in the taxing State. *See J.C. Penney Nat'l Bank v. Johnson*, 19 S.W.3d 831, 840-41 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000). However, a later decision by the same intermediate appellate court cautions against too broad a reading of the decision in *J.C. Penney*. *America Online, Inc. v. Johnson*, No. M2001-00927-COA-R3-CV, 2002 WL 1751434 at *2 (Tenn. Ct. App. July 30, 2002), declined to read *J.C. Penney* to "substitute 'physical presence' for 'nexus' as the first prong of the *Complete Auto Transit* test" in a challenge to a tax on an internet service provider. Petitioners claim that in *America Online* "Tennessee has not retreated from the holding in *J.C. Penney*," Pet. 22-23, but the implication of *America Online* is clear: *J.C. Penney*

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[1] United States Supreme Court Rule 10(b) generally limits the Court's consideration of a conflict of state decisions to those by "the highest court of a state." *Id.* Thus, the Court "tries to achieve uniformity in federal matters only among the various courts whose decisions are otherwise final in the absence of Supreme Court review." R.L. Stern, *et al.*, *Supreme Court Practice* (9th ed. 256).

stands alone among the States and the decision has limited force even on its home field. *Cf. Wisniewski v. United States*, 353 U.S. 901, 902 (1957) ("It is primarily the task of [a lower court] to reconcile its internal difficulties.").

Nor does the 1993 decision of the Michigan Court of Appeals in *Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349 (Mich. App. 1993), demonstrate a significant split of state authority. *Guardian* did not strike down any tax, much less resolve the issue presented here. Rather, it involved the question whether certain taxpayers with undeniable physical presence in Michigan could exclude from Michigan's "single business tax" certain of its "sales" of tangible personal property outside Michigan on the ground that they were taxable in other States. *Id.* at 352, 353. In the unusual posture in which the case arose, it was the taxpayers that urged that their nexus in other States was sufficient for taxation by those States; Michigan argued that nexus was insufficient in those States, and the taxing authorities in the other States were not involved in the case. One taxpayer stipulated that its activities in the non-Michigan States were limited to mere solicitation, and so was found not to be taxable there by the non-Michigan States. *Guardian* thus turned on whether the level of these activities forfeited the statutory immunity conferred by P.L. 86-272, 15 U.S.C. § 381, not whether they reached the threshold level of constitutional nexus. *Guardian* thus does not hold that a state income or franchise tax requires a physical presence; at most, it holds that in some circumstances a tax on a

company whose in-state activities do not exceed the solicitation of sales of tangible goods may be foreclosed by a federal law limiting state taxation, such as P.L. 86-272. But that issue is not the same as that presented here. Finally, *Guardian* has little remaining force even in Michigan: the Michigan legislature has eliminated the tax at issue in *Guardian* and enacted a new tax that does not require a physical presence. MCL 208.1200(1).

Nor does the 2000 decision of the Texas Court of Appeals in *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. App. 2000), establish a current and significant conflict. In striking down the application of a state franchise tax, the Texas intermediate appellate court repeatedly stressed that the State had applied its franchise tax "solely" on the basis of the taxpayer's passive possession of a "certificate of authority" to do business in Texas. *Id.* at 298, 299, 300.[2] Despite broader *dicta*, therefore, *id.* at 300, *Rylander* does not strike an income or franchise tax where the State relies on active licensing of a taxpayer's valuable intangible property

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[2] Texas relied on the certificate of authority because it was state "*policy*" that "the licensing of intangibles, including patents, in Texas did not create franchise tax nexus." *Id.* at 302 (emphasis in original). Thus, Texas did not rely on the patent royalty payments that Bandag received from its Texas affiliate. The court indicated that the taxpayer's "sole activity" of relevance connecting it to Texas was "communication by United States mail and common carriers," without identifying any economic activity (except perhaps its licensing activities, which Texas did not count) that was the subject of such communication. Id. at 300.

for use within the taxing States, where the taxpayer derives substantial royalty income from such use.

In sum, the decisions of the state courts do not demonstrate "a mature, well-recognized, and entrenched split of authority." Pet. 16. They represent instead (1) a growing consensus among recent decisions and (2) minor historical anomalies from States that have joined or might later defer to the recent and clear trend. *Cf. Portland 76 Auto/Truck Plaza, Inc. v. Union Oil Co.*, 153 F.3d 938, 943 (9th Cir. 1998) ("Because of the importance of predictability to commercial relations, as well as deference to our sister circuits, we shall not lightly create an intercircuit conflict affecting commerce nationally."). For these reasons, the decisions cited by petitioners do not support plenary review of the issue presented at this time.

III. THE COURT SHOULD NOT GRANT REVIEW BASED ON MERE SPECULATION ABOUT BURDENS ON INTERSTATE AND FOREIGN COMMERCE.

A. Speculative Claims About an "Undue Burden" on Interstate Commerce Do Not Support Plenary Review of the Issue Presented.

Petitioner argues that the rule applied by the SJC will have "severe economic implications." Pet. 33. It claims that a corporation will be unable "to order its business affairs and determine in what

States it can be subject to state income and franchise tax." Pet. 34. For the reasons stated below, these alleged burdens on interstate commerce do not justify plenary review in this case.

The SJC correctly rejected the same exaggerated predictions of doom by corporate net-income taxpayers and *amici curiae* in the related case of *Capital One Bank*. Contrasting the sales and use taxes addressed in *Quill*, the SJC stated that "an income-based excise . . . typically is paid only once a year (except when quarterly estimated taxes are required), to one taxing jurisdiction on the state level, and the payment of such an excise does not entail collection obligations *vis-à-vis* consumers." 899 N.E. 2d at 85 n.17 (citations omitted). The SJC continued:

> Determinations about whether the [banks] are subject to the [tax] . . . or how to apportion income from business activity that is taxable within [Massachusetts] are the sorts of decisions that, more broadly, can confront all taxpayers, local or out-of-state, when calculating, reporting, and paying taxes on their income. While the making of these determinations is certainly more complex for large corporate taxpayers, it is part of the cost of doing business and is not, in our opinion, unduly burdensome on interstate commerce, particularly where such taxpayers, like the [petitioners] are earning substantial income from their business activities in Massachusetts and where the common usage of computer

technology and specialized software has eased the administrative burdens of tax compliance.

Id.

Having failed to convince the SJC of an "undue burden" on commerce, petitioner and *amici curiae* now flood the Court with a new round of speculation about the impact of the nexus rule upheld in this case. But speculation does not establish clear proof that this case is of such "gravity and importance" as to warrant review by this Court. *See In Re Woods*, 143 U.S. 202, 206 (1892).

As the party urging a new rule of physical presence for corporate income taxes, petitioner has the burden to show an impact requiring intervention by this Court. Petitioner has not met its burden. It grossly exaggerates when it claims that the rule applied by the SJC will have "severe economic implications." Pet. 33. As petitioner concedes, taxpayers selling tangible goods, if they have no physical presence in the taxing State, may be protected from tax by P.L. 86-272, 15 U.S.C. § 381. Similarly, small and medium size businesses may be protected by (1) statutory thresholds protecting *de minimis* contacts or (2) the Due Process Clause.

Nor is plenary review supported by petitioner's statement that "many administrative . . . decisions on the question have been issued by other States." Pet. 5 n.1. Petitioner does not cite new litigation or practical problems arising from these developments, thus tending to prove that the approach is workable and not unduly burdensome.

If issues later arise, they should be allowed to proceed through the state courts, where records could be developed to allow for full consideration of the alleged burdens of compliance. It is premature, however, to conclude that recent state actions will produce a conflict of authority requiring intervention by this Court.

Finally, petitioner's claims about burdens on commerce ignore the other restraints imposed by the Commerce Clause, *viz.*, the requirements that any tax be fairly apportioned, non-discriminatory, and fairly related to a State's services. These other tests under *Complete Auto* address many of the specters that petitioners and *amici curiae* conjure in arguing for a physical presence requirement for nexus. The petition and the briefs of the *amici curiae* ignore the fact that issues regarding discrimination and multiple taxation are separate and distinct from nexus. These separate claims against state taxation do not support review of the nexus question presented in this case.[3]

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[3] Petitioner argues that a "physical presence" rule is preferable to the rule applied by the SJC because the physical presence test alone is a "bright line" rule. But decisions of state courts demonstrate that the physical presence test has its own ambiguities. *See, e.g., Dell Catalog Sales*, 199 P.3d 863 (N.M. Ct. App. 2008), *cert. denied*, 129 S.Ct. 1616 (2009).

B. The Alleged Impact on Foreign Commerce Was Not Raised Below and In Any Event Does Not Support Review by this Court.

Petitioner also argues that the "economic nexus standard has adverse global implications." Pet. 36-38. Petitioner made no claim under the Foreign Commerce Clause in the SJC. *See Brief for Geoffrey, Inc., Appellant*, 2008 WL 4359876 (January 31, 2008). "In cases coming [to the Court] from state courts, there are reasons of peculiar force which should lead [the Court] to refrain from deciding questions not presented or decided in the highest court of the state . . . ." *McGoldrick v. Compagnie Generale*, 309 U.S. 430, 434 (1940). Even if petitioner has preserved the issue, or merely cites the alleged impact on foreign commerce as evidence of the importance of the question presented, its argument does not support plenary review. Such arguments by petitioners and *amici curiae* have not been documented or examined in these proceedings. If a foreign corporation later challenges a tax on such grounds, it may create a full record and seek review by this Court at that time. Meanwhile, as explained below, the policy arguments made by the petition should be addressed to Congress, not the Court.

IV. THE COURT SHOULD DENY THE PETITION IN DEFERENCE TO THE CONSTITUTIONAL ROLE OF CONGRESS IN WEIGHING BURDENS ON INTERSTATE COMMERCE.

Petitioner argues that "[a]bsent clear guidance from this Court," there will be adverse economic effects on multi-state businesses. Pet. 34. To the contrary, the Court should deny the petition because the issue presented is better decided by Congress, which this Court has said has power under the Commerce Clause to "evaluate the burdens that taxes impose on interstate commerce." *Quill*, 504 U.S. at 36. Whatever ruling that this Court might make on the merits of the issue presented here, "Congress remains free to disagree with [the Court's] conclusions." *Id.* As petitioner notes (Pet. 27 n.5), Congress has enacted limitations on state taxation. *See, e.g.*, 15 U.S.C. § 381; 15 U.S.C. § 391; 49 U.S.C. § 11501. Regarding the issue presented here, Congress has for at least eight years considered bills directly addressing the issue, including a bill pending in the current session of Congress. Business Activity Tax Simplification Act of 2009, H.R. 1083, 111th Cong. (2009).

Despite these legislative vehicles for action, petitioner states that "Congress has given no indication in the nearly two decades since Quill" that it "intends to follow up . . . ." Pet. 5. But this point ignores the most important inference from the fact of the bills: they show that the issue presented is by its nature one that Congress is "better qualified to

resolve." *Quill*, 504 U.S. at 318 and n.11. Thus, in *Quill* the Court cited unenacted bills in its discussion of Congress's relative competence regarding the same issues. The Court recognized that Congress is "better qualified" to conduct a full study of the relevant factors, including alleged burdens on business and likely fiscal impacts on the States. These issues are ones involving legislative fact. They are better weighed by Congress in hearings, reports, and debates. *See, e.g., Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. On State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966). Where, as here, taxpayers seek a broad exemption from tax, Congress is better qualified to judge the impact of the exemption on other commerce and other types of state taxation.

Petitioner cites business "uncertainty" that is "costly" and "inhibits strategic business planning" (Pet. 34), but these factors are by their nature legislative facts that Congress is well suited to weigh. Judicial review of the same questions, in contrast, is necessarily limited by the four-corners of a judicial record and the retrospective cast of a lawsuit. Judicial conclusions about respective burdens will necessarily be both limited and speculative. The Court has warned that the judiciary "must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution but merely represent judicial generalizations exceeding the concrete circumstances which they profess to

summarize." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940). For these reasons, the Court should defer to the legislative role expressly conferred on Congress by the Commerce Clause.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be denied.

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No. 08-1207

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In The Supreme Court of the United States

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Unable to demonstrate why *certiorari* should not be granted, respondent, instead, misstates several critical aspects of petitioner's arguments and attempts to obfuscate the single, significant issue in this dispute.

The sole question in this case is the continued vitality of the "substantial nexus" prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and this Court's decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). That this case involves a single, clean constitutional question makes this case an ideal vehicle for this Court to decide the most significant constitutional question affecting state taxation to come before the Court in decades.

While the "substantial nexus" prong and its physical presence requirement are all that are before the Court, respondent is wrong when it claims that petitioner conceded that it is "doing business" in Massachusetts, that it is subject under state law to the corporate net income tax or that the tax asserted against it by the Commonwealth was fairly apportioned, nondiscriminatory and fairly related to the services provided by the State. Petitioner simply has not pursued those issues under *Complete Auto* for the Court's benefit—to ensure that this case, as it now is presented to the Court, would be devoid of any collateral factual disputes that might undermine this Court's review.

Sixteen state appellate courts have divided on the question presented; respondent does not dispute that fact. That alone should compel this Court's review. But beyond that widespread and mature conflict, this Court's review is necessary because the court below, and many other state courts, have rewritten, misread, and fundamentally ignored this Court's constitutional precedents, and they have shifted the tax burden from its individual voting citizens and businesses that are physically present and thereby place demands on the State's infrastructure to out-of-state businesses that lack any physical presence in the State and thus impose no governmental costs, merely because those out-of-state businesses have earned income having some tenuous connection with that State.

I. CORRECTED STATEMENT OF JURISDICTION

Respondent correctly notes jurisdiction does not lie in this Court under 28 U.S.C. § 1254(1); this Court's jurisdiction is invoked under 28 U.S.C. § 1257(a).

II. BECAUSE THE MASSACHUSETTS SUPREME JUDICIAL COURT'S DECISION CONFLICTS WITH THIS COURT'S PRECEDENT AND THE DECISIONS OF OTHER STATE COURTS, THIS COURT'S INTERVENTION IS CRITICAL

A. The Conflict Between State Courts Is Real And Substantial

Respondent concedes that the state courts are divided (Opp. 15) on an important constitutional issue that profoundly affects this Nation's businesses in a time of economic uncertainty. Rather than acquiesce to *certiorari* being granted, to provide the necessary certainty that both State and businesses alike require, respondent attempts to minimize the conflict among *sixteen* state appellate courts as to the scope of *Bellas Hess* and *Quill* by claiming the cases are old or that subsequent statutes have been enacted to eliminate a physical presence requirement.

Precedents, however, have no automatically expiring "shelf life." Opp. 15 (claiming that certain conflicting decisions of other jurisdictions are "now well past [their] shelf life."). The precedents of state courts, like the precedent of this Court, remain good law until they are overruled. Indeed, two of the precedents respondent criticizes as stale—or "historical anomalies"—were decided within the past decade. Opp. 21.

More significantly, respondent cannot demonstrate that the decisions of the state courts in Tennessee, Michigan, and Texas—all of which impose a physical

presence requirement—are no longer good law. And, as the petition makes clear, the rulings of those courts are binding and have not been revisited. *See* Pet. 21.[1]

Nor is it of any consequence that there might be some contextual differences between the decision of the Tennessee, Michigan and Texas courts and the instant case. Respondents have not disputed, and cannot dispute, that each of those courts held that a physical presence is *necessary* for a jurisdiction to tax. *See Guardian Indus. Corp. v. Department of Treasury*, 499 N.W.2d 349, 356 (Mich. Ct. App. 1993) ("after *Quill* it is abundantly clear that Guardian must show a physical presence within a target state to establish a substantial nexus to it"), *appeal denied*, 512 N.W.2d 846 (Mich. 1994); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296, 300 (Tex. Ct. App. 2000) ("While the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basis issue remains whether the state can tax the corporation at all under the Commerce

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[1] The subsequent *unpublished* opinion in *America Online, Inc. v. Johnson*, No. M2001-00927, 2002 WL 1751434 (Tenn. Ct. App. July 30, 2002), could not call *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999), *cert. denied*, 531 U.S. 927 (2000) into doubt, and, in any event, it was not appealed to the Tennessee Supreme Court so it could not overrule prior precedent adopted and approved by that Court. *See* Tenn. S. Ct. R. 4(G)(2). In any event, *America Online* addressed whether the conduct of third parties in the State met the "physical presence test." *See* 2002 WL 1751434, at *3.

Clause. * * * [W]hen the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.").

The court below should not be able to evade this Court's review merely because the majority of the sixteen state appellate courts to have addressed this issue have followed the recommendations of their state departments of revenue. This rubber-stamped "everybody else is doing it" (Br. of Tax Executives Institute, Inc. as *Amicus Curiae*, at 12) approach in order to uphold constitutionally unsupportable tax revenue streams cannot be a substitute for reasoned, revenue-blind objective analysis that only this Court, insulated from the political pressures of revenue shortfalls and special elections, can provide.

The conflict is real, current and pressing to businesses and States alike. It speaks volumes that, in the companion case to *Geoffrey*, *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009), No. 08-1169, South Dakota and Virginia have joined Capital One Bank in urging this Court to grant *certiorari* to provide the missing "clarity." Br. of the Commonwealth of Virginia, Joined By South Dakota, as *Amici Curiae*, at 2. Although these States take no position on the issue, they recognize that "[t]he lower courts are divided with respect to the 'nexus' required under the Commerce Clause." *Id.*

B. This Court's Precedent And Not Its *Dicta* Must Be Followed By All Of This Nation's Courts

Even if the physical presence requirement of *Bellas Hess* and *Quill* should be narrowed to just sales and use taxes, review is still required because only this Court, and not the state courts that have divided on this issue, should be permitted to overrule the precedent of this Court. This Court has made clear that its holdings, and not its *dicta*, are the precedent that must be followed. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989) ("If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions.").

In their efforts to justify departure from the long-standing precedents of this Court in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), which require a physical presence before a State can assert jurisdiction to tax, the Massachusetts Supreme Judicial Court and the courts of several other States have argued that *Quill* requires less respect because it relied in part on *stare decisis* (Opp. 11-12) and have cited to certain *dicta* in

Quill (Opp. 13).[2] Neither respondent nor the court below, however, cites to any decision of this Court which holds that physical presence is not required for substantial nexus outside the sales and use tax context. Respondent also cites to no decision of this Court holding that the Commerce Clause is tax-specific or industry-specific.

Moreover, the claim that there should be a distinction between sales and use taxes, on the one hand, and income and franchise taxes, on the other, due to relative compliance burdens in nonsensical. No principled justification exists under the Commerce Clause to determine *jurisdiction* based on relative administrative burdens. In any event, the *amici curiae* in this case each examine the relative burdens of sales and use tax compliance to income and franchise tax burdens and have each concluded that the latter taxes place greater burdens on businesses from both compliance and economic vantage points. Br. of *Amici Curiae* Council on State Taxation, National Association of Manufacturers, and National

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[2] The *dicta* is found in two sentences in *Quill*. The first was: "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." 504 U.S. at 314. The second was: "In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.* at 317.

Marine Manufacturers Association, at 8-15; Br. of Tax Executives Institute, Inc. as *Amicus Curiae*, at 20-21; Br. of *Amicus Curiae* The Sherwin-Williams Company, at 12-19; Br. of *Amicus Curiae* Institute for Professionals in Taxation, at 11-14. Indeed, "[p]erhaps the real dichotomy here may not be between sales and income taxes * * * but how the limitations set forth in the United States Constitution can be avoided to provide the State with a better opportunity to expand its taxing opportunities." *Tax Comm'r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226, 239 (W. VA. 2006) (Benjamin, J., dissenting).

C. "Substantial Nexus" Does Not Mean "Substantial Revenue"

Review also is necessary because the decision below seeks to fundamentally alter the first prong of the *Complete Auto* framework. Rather than require the State have a "substantial nexus" to the taxpayer, respondent would require only that there be "substantial revenue" generated from within the State.[3] As *Complete Auto* makes clear, however, there

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[3] Respondent thus repeatedly has focused on the amount of royalties petitioner received from Massachusetts businesses. Opp. 10. That amount of royalties received has no bearing on whether petitioner has "substantial nexus" with the State. If anything, the amount of royalties demonstrates the economic significance of this case and the need for this Court's review. Respondent, just one of fifty state departments of revenue, seeks to tax over $33 million of revenues of petitioner. When aggregated across the Nation (and when every business subject

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are separate requirements *all* of which must exist before jurisdiction to tax will satisfy the Commerce Clause, and nowhere does the Constitution look to the amount of revenue generated within the State to determine whether that State has jurisdiction to tax it.

It is for that reason that respondent's comparison of a business owning and leasing a storefront in Massachusetts to a business owning and licensing intellectual property (Opp. 14) demonstrates the need for this Court's immediate review. Respondent's hypothetical reveals the problem of a nexus standard not predicated on physical presence. *Complete Auto's* fourth prong requires that a State tax must "be fairly related to the services provided by the state." 430 U.S. at 279. Since *no* services are provided to the business owning and licensing intellectual property, *no tax* can be fairly related to nonexistent services. Governmental services (*e.g.*, police, fire) are, however, provided with respect to the property physically present in the State.[4] Imaginary services conjured up

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to these inconsistent state court requirements is taken into account), the burden imposed upon the Nation's businesses unquestionably equal billions of dollars.

[4] Indeed, the instant case demonstrates the fallacy of respondent's example. Despite its contention that Geoffrey had "activities in Massachusetts," (Opp. 8) respondent agrees that "Geoffrey's entire business consisted of licensing its intellectual property," which is inherently passive. While respondent claims that petitioner "retained the right to preview and disapprove product samples" and "access to both Massachusetts courts and federal courts located in Massachusetts" (Opp. 10), petitioner

(Continued on following page)

to justify the imposition of millions of taxes are insufficient to satisfy the fair relationship prong of *Complete Auto*. Indeed, this Court in *Quill* rejected the North Dakota Supreme Court's conclusion that a constitutionally significant nexus was generated by North Dakota's creation of "an economic climate that fosters demand." *Quill*, 504 U.S. at 304 (citation omitted).

The "substantial revenue" standard respondent proposes (and the court below implicitly adopted) is in reality a Due Process nexus standard which, as explained by this Court in *Quill* would apply to any company that "purposefully avails itself of the benefits of an economic market in the forum State." *Quill*, 504 U.S. at 307-308. That standard was advocated by North Dakota in its case against *Quill*, a company that earned almost $1 million of yearly revenue from its North Dakota customers. This Court, however, has held that the Commerce Clause requires more, and there is no reason now for this

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did not use Massachusetts courts or federal courts located in Massachusetts during the years at issue. Pet. App. 8a n.7. No activity was conducted by petitioner in Massachusetts that would support the requirement that "interstate commerce 'pay its own way.'" Opp. 14 (citation omitted). In short, petitioner received *nothing* from Massachusetts or its consumers. It received royalties based on the sales made by affiliates that operated retail stores in Massachusetts, sales which the State subjects to a net income tax levied on those retail affiliates and a sales tax rendered on purchasers of the goods sold by the retailers.

Court to permit state courts to retreat from that precedent.

D. The Burdens Imposed By The Decision Below Are Not Speculative

Respondent's attempts to minimize the burdens on interstate commerce of the ruling below are belied by the numerous *amicus* briefs in support of Geoffrey's petition and in support of the companion case, *Capital One*. These *amici* substantiate the very real and current burdens businesses face if this Court does not intervene:

- "[T]his Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce." Br. of *Amici Curiae* Council on State Taxation, National Association of Manufacturers, and National Marine Manufacturers Association, at 3.

- "The holdings of the Massachusetts court in *Capital One* and the instant case cast an ominous shadow over the protections accorded interstate businesses by the Commerce Clause of the Constitution." Br. of Tax Executives, Inc. as *Amicus Curiae*, at 7.

- "This issue is the most significant state and local tax question pending today. The associated tax and compliance cost implications, in the billions of dollars, are of special concern to small businesses because of the resulting disproportionate impact they occasion." Br. of *Amicus Curiae* Institute for Professionals in Taxation, at 2.

- "[T]he ambiguity surrounding the issue of state income tax nexus interferes with corporations' abilities to conduct themselves in the interstate marketplace." Br. of *Amicus Curiae* The Sherwin-Williams Company, at 22.

- "If states are allowed to tax the income of citizens and corporations of other states or nations based on this nebulous economic nexus standard, the delicate balance carefully established by numerous international tax treaties will be upset, causing serious disruption to the expectations of international businesses that engage in commerce with U.S. persons." Br. of the Clearing House Association, The National Foreign Trade Council, The Organization for International Investment, The Securities Industry and Financial Markets Association, and the United States Council for International Business as *Amici Curiae*, at 3, filed in *Capital One Bank v. Commissioner of Revenue*, No. 08-1169.

- "[T]he States need clarity in the law. At present that clarity is missing." Br. of the Commonwealth of Virginia, Joined by South Dakota, as *Amici Curiae*, at 2, filed in *Capital One Bank v. Commissioner of Revenue*, No. 08-1169.

E. The Absence Of Congressional Intervention Makes This An Issue For This Court To Decide

Petitioner does not dispute that this is a question that Congress can, if it so chooses, decide. Congress is free to adopt a jurisdictional threshold under the Commerce Clause that is different and more burdensome than the physical presence requirement set out by this Court in *Quill*. Despite the passage of 17 years from *Quill* (and more than 40 years since *Bellas Hess*), however, Congress has not done so.

The absence of any word from Congress should not permit the States to enact new state taxes that retreat from this Court's Commerce Clause precedent. As this Court has recognized in other contexts, "[a]bsent 'a clear expression of approval by Congress,' any relaxation in the restrictions on state power otherwise imposed by the Commerce Clause unacceptably increases 'the risk that unrepresented interests will be adversely affected by restraints on commerce.'" *Maine v. Taylor*, 477 U.S. 131, 139 (1986) (citation omitted). Because Congress has not spoken, there has been no clear statement that would justify the decision below.

In any event, it is the *dicta* in this Court's decision in *Quill* that is the genesis of the question of whether its stated physical presence standard applies beyond sales and use taxes. This Court is therefore in the best position to answer that question and determine whether the States have properly supplanted the Court's physical presence Commerce Clause standard with an economic presence test.

CONCLUSION

For the reasons set forth above and in the petition, the petition for a writ of *certiorari* should be granted.

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GEOFFREY, INC.,
Petitioner,

v.

COMMISSIONER OF REVENUE OF MASSACHUSETTS,
Respondent.

On Petition for a Writ of Certiorari to the Commonwealth of Massachusetts Supreme Judicial Court

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INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioners is filed on behalf of three trade associations representing the largest businesses in our nation's state and local economies.[1] Unless this Court clarifies whether in-state physical presence remains the standard by which a business becomes subject to a state's income and franchise tax jurisdiction, the thousands of members of *amici's* associations will face substantial costs in determining their tax liabilities and in some instances will not be able to ascertain those liabilities accurately at all. This uncertainty regarding tax compliance obligations increasingly creates significant and impermissible burdens on interstate commerce.

The Council On State Taxation ("COST") is a nonprofit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. COST represents more than 600 of the largest multistate businesses in the United States, including companies in every industry. Many of COST's members have customers in states where the members have no property or employees—that is, in states where the members have no "physical presence."

The National Association of Manufacturers ("NAM") is the nation's largest industrial trade association, representing small and large manufac-

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. The parties received timely notice of *amici's* intent to file this brief. Written consent of all parties to the filing of this brief has been filed with the Clerk of this Court.

turers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media, and the general public about the vital role of manufacturing to America's economic future and living standards.

The National Marine Manufacturers Association ("NMMA") is the nation's largest recreational marine industry association, representing more than 1,500 boat builders, engine manufacturers, and marine accessory manufacturers. The recreational boating industry is a substantial contributor to the nation's economy with sales of recreational marine products and services totaling more than $37.5 billion in 2007 alone. Because their business activities are typically multistate in nature, the NMMA's members have an important interest in the question presented. In addition, the majority of NMMA members are small businesses with limited resources to navigate complex state tax regimes.

SUMMARY OF THE ARGUMENT

Historically, a corporation's physical presence in a state served as the prerequisite for any type of tax, including income and franchise tax. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 754 (1967), and *Quill v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the context of sales and use taxes. However, many states continue to expand aggressively their own tax revenues by asserting the power to tax the corporate income of out-of-state businesses that have no physical presence in the taxing state. States have

adopted a variety of expanded "nexus" standards through judicial, legislative, and administrative action. These standards—which are unclear and vary widely from state to state—are highly burdensome for taxpayers doing business in multiple jurisdictions and thus place an enormous burden on interstate commerce. As the scope of these standards have been judicially tested, the highest courts of Massachusetts, West Virginia, New Jersey, and South Carolina have all held that the Commerce Clause does not prevent the imposition of income and franchise taxes upon out-of-state corporations with no physical presence in the state. While some state appellate courts have issued similar decisions, others have held the opposite.

The importance of the Court's review of the Massachusetts decisions extends well beyond the direct conflict among state courts regarding the meaning of the Commerce Clause. To be sure, this Court's review is urgently needed because departures from the physical presence rule and the resulting uncertainty over the jurisdictional grounds of state taxation have themselves generated an impermissible burden on interstate commerce. Thus, these cases present the special circumstance where divergent approaches by different states have produced the very constitutional evil that the Commerce Clause was meant to avoid.

The uncertainty in calculating a multistate business's state income or franchise tax liability stems both from (i) the divergent approaches taken by different states and (ii) the nebulous and unpredictable nature of alternatives to the physical presence rule. The uncertainty generates a considerable increase in compliance costs and administrative burdens, as well as problems in determining and reporting the business's tax liability for required financial statements.

A business that cannot accurately ascertain its tax liability, even internally, can hardly be expected to make meaningful disclosures to investors. As a result, there are real economic losses when a company decides not to exploit an otherwise profitable opportunity (such as expanding its business into a new state) because of the expense and uncertainty inherent in state tax jurisdiction rules. The abandonment of the traditional "physical presence" rule thus entails deadweight losses (in the form of unnecessary compliance costs), lower business productivity, slower growth, fewer jobs, and additional burdens on interstate commerce. The same reasons that animated this Court's grant of review in *Quill* militate strongly in favor of certiorari in these cases. In fact, this Court's review is much more compelling here than in *Quill* because state corporate income taxes are more burdensome than the collection of sales and use taxes. The costs of compliance are much greater, and the threat to interstate commerce is immediate.

ARGUMENT

I. UNCERTAINTY REGARDING STATE AND LOCAL TAX COMPLIANCE OBLIGATIONS CREATES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE

A. The Physical Presence Rule Is Necessary To Provide Clarity and Predictability

Physical presence has traditionally served as the basis for the imposition of corporate income and franchise taxes. In *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 (1967), this Court held that a systematic program of direct mail advertising was not sufficient to justify imposition of use tax on an

out-of-state seller. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), this Court reaffirmed the physical presence rule in the sales and use tax context as a limit "firmly establish[ing] the boundaries of legitimate state power." *Id.* at 315.

The physical presence rule is a bright-line rule that provides a business with an adequate understanding of when and where it will be subject to tax. As a leading constitutional scholar has observed, the rule "provides some measure of stability to parties engaged in commercial interchange and provides a more hospitable environment for the flourishing of nascent modes of free-floating interstate commerce, which might otherwise perish on the rocky shoals of overmuch state taxation." 1 Laurence H. Tribe, AMERICAN CONSTITUTIONAL LAW 1125 (3d ed. 2000).

However, some states have departed from the physical presence rule in the imposition of corporate income and franchise taxes. Massachusetts has adopted an "elastic" substantial nexus test, which would permit the State to tax the income of any business with *customers* in the taxing state, even if it lacked any real or tangible personal property, employees, or other contacts there. Other states have adopted their own "nexus" standards, whose nebulous nature and non-uniform definitions make it highly burdensome for multistate businesses to comply. *See, e.g., Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13, 18 (S.C.) *cert. denied*, 510 U.S. 992 (1993) ("by licensing intangibles for use in this State and deriving income from their use here, [taxpayer] has a 'substantial nexus'" with state); *see also Buehner Block Co. v. Wyo. Dep't of Revenue*, 139

P.3d 1150, 1158 n.6 (Wyo. 2006).[2] Still other states have made statutory or administrative changes asserting authority to tax corporations with no physical presence.[3]

As states adopt their own versions of a "nexus" test, multistate taxpayers face a variety of different standards and vague guidelines. Taxpayers are denied a clear understanding of their tax liabilities as states base their "determinations of whether nonresident corporations are subject to tax on a subjective facts and circumstances analysis". Megan A. Stombock, *Economic Nexus and Nonresident Corporate Taxpayers: How Far Will It Go?*, 61 THE TAX LAWYER 1225, 1238 (2008). It is often unclear to taxpayers whether they are even required to pay tax in a jurisdiction at all. As observed by commentators:

> [W]e are now in a world in which a business, remotely present in multiple states, is faced with a wide range of nexus standards regarding the

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[2] *See also Bridges v. Geoffrey, Inc.*, 984 So.2d 115 (La. Ct. App. 2008), *writ denied*, 978 So.2d (La. 2008); *Lanco, Inc. v. Director, Div. of Tax.*, 908 A.2d 176 (N.J. 2006), *cert. denied*, 127 S. Ct. 2974 (2007); Kmart *Props., Inc. v. Taxation & Revenue Dep't of N.M.*, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed*, 131 P.3d 22 (N.M. 2005); *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. Ct. App. 2004), *cert. denied*, 546 U.S. 821 (2005); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005); *Gen. Motors Corp. v. City of Seattle*, 25 P.3d 1022 (Wash. App.), *pet. rev. denied en banc*, 84 P.3d 1230 (Wash. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Tax Comm'r v. MBNA America Bank*, 640 S.E.2d 226 (W. Va. 2006), *cert. denied*, 127 S. Ct. 2997 (2007).

[3] *See, e.g.*, Ark. Reg. 1996-3 (2009); Fla. Admin. Code Ann. r. 12C-1.011 (p)1 (2009); Iowa Admin. Code r. 701.52.1(422), 52.1(1)d (2009); Minn. Stat. § 290.015(1)(c)(3) (2009); Okla. Admin. Code § 710:50-17-3(a)(9) (2009).

> complex commercial transactions. The convergence of these trends, the blurring of nexus standards, and the increasing complex global economy call into question the ability to fairly administer the current state and local taxing system.

Giles Sutton, Eric de Moya, and Chuck Jones, *Attributional Nexus, Flash Title, And the Chaos in Nexus Standards*, 50 STATE TAX NOTES 491 (2008).

Two months ago, Wisconsin significantly changed its law pertaining to economic nexus without any hearings or public debate. The new law, which imposes tax on anyone "regularly soliciting business from potential customers in this state," raises many difficult questions taxpayers must address to determine precisely what activities give rise to economic nexus in the State. Wisc. Stat. § 71.22(1r) (2009).

The current confusion surrounding income tax nexus is not that different from the situation this Court faced in *Quill* when addressing sales and use taxes. The Court acknowledged then "our law in this area is something of a 'quagmire' and the 'application of constitutional principles to specific state statutes leaves much room for controversy and confusion and little in the way of precise guides to the States in the exercise of their indispensible power of taxation." *Quill*, 504 U.S. at 315 citing *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457-58 (1959)). The current uncertainty offends the core values protected by the Commerce Clause and amply warrants this Court's review.

B. Departures From The Physical Presence Rule Create Substantial Compliance Costs For Multistate Businesses

In *Quill*, this Court recognized that anything but a physical presence rule would be an undue burden on interstate commerce, because of the significant cost of compliance with sales and use tax laws in a multistate environment. The same conclusion applies *a fortiori* in these cases, because corporate income tax compliance is substantially more complex and burdensome than the sales and use tax compliance analyzed in *Quill*. In the sales and use tax context, only two broad questions must be asked and answered: Is the item taxable or non-taxable? If the item is taxable, what is the applicable tax rate? The burdens uniquely associated with uncertainty are few with respect to sales and use taxes, because compliance is straightforward.

In contrast, corporate income tax is demonstrably more complex because there are dozens of independent questions and judgments that must be made in calculating a corporate income tax liability. Without a physical presence rule, companies would need to examine these questions on a jurisdiction-by-jurisdiction, corporate-entity-by-entity, and year-by-year basis. Record-keeping in the corporate income tax context is also significantly more elaborate than in the area of sales and use taxes where only the records of sales need be retained. The number of potential taxing jurisdictions at the state and local level that can impose a business activity tax is dramatically higher than the number of jurisdictions imposing a sales and use tax. *See Quill*, 504 U.S. at 313 n.6. Multistate businesses face the prospect of

taxation not only in 50 states, but also in thousands of localities authorized to impose corporate income, franchise and other business activity taxes.

In the absence of a physical presence rule, multistate businesses will face significant costs in trying to determine the jurisdictions in which they face potential tax liabilities and the applicable rules of those jurisdictions. Some may be unable to ascertain accurately their tax liabilities at all. Each multistate business—large and small—must analyze a long list of issues for every jurisdiction where it has a commercial profile. Listing all of the issues a taxpayer must address before complying with the numerous individual state income tax rules would easily exceed the maximum page count allowed for this brief. However, an abbreviated description of the archetypal issues can provide a hint of the task involved.

1. Return Filing Methods

States have numerous types of income tax returns with inconsistent and overlapping names and frequently opaque rules. While some states adopt standard federal consolidated reporting concepts, most do not. The lack of any uniformity in this area creates an enormous burden on any taxpayer seeking to comply. A passing list of the issues a taxpayer faces when choosing the appropriate type of return includes:

- Is combined reporting (a method where affiliated businesses file as one unit) allowed, prohibited, or elective?
- What are the requirements for an affiliate to be included or excluded from the combined report?

- What are the ownership rules for an affiliate to be eligible for inclusion in the combined report? Are there beneficial ownership rules? What types of stock are considered in the ownership test—preferred stock, convertible bonds, restricted stock?
- Does the state require only that the affiliates be unitary?
- What is the definition of a "unitary business" in any given state—the "contribution and/or dependency test," the test articulated in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), the test cited in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), or a state-created test?
- Does the state have some type of additional test such as a requirement that the calculation of a company's income tax is distortive? If so, what is considered distortion?
- How are partnerships and other pass-through entities treated? Is the pass-through entity included in the combined report if its majority owner is the combined group? Is only its income allocated to the member included in the tax base or is its total income included?
- What types of entities and businesses may or must be included in a combined return and which must be excluded? For example, may an insurance company be included with its non-insurance affiliates? Are Puerto Rico affiliates included?

2. Filing Requirements and Mechanics

Once the type of return and which entities should be included on the return is determined, the taxpayer must determine how to file and pay the tax, obtain a refund, or seek an extension.

- When are estimated tax payments due? Are payments due ratably throughout the year, or are different percentages of tax due at different estimate dates? What happens to short tax years?
- Must the return be filed electronically? Must the payment be sent electronically?
- What are the procedures for amendments and adjustments? Some states piggy-back onto federal extension filings while others require separate applications for an extension of time to file a tax return.

3. Tax Base Computations and Adjustments

Multi-jurisdictional taxpayers also face differing state definitions of the tax base. Most states use federal taxable income as a starting point, but five states do not. Even among the states that use federal taxable income as the starting point, every state has unique addition and subtraction modifications that result in a substantial divergence in the ultimate state tax base from the federal base (and among the states' bases themselves). Corporations typically must keep numerous schedules for each state to track the differences in asset and liability basis, net operating losses (NOLs), depreciation, and other variations from the federal rules.

Typical issues that taxpayers face include:

- Does the state follow federal depreciation rules? Most states have departed from the federal bonus depreciation in recent years, but many departed in differing ways. This means taxpayers must keep multiple sets of depreciation calculations for the same business equipment.
- How does a state calculate NOLs? Does it follow the federal carryback and carryforward rules, or does it have its own time period? Taxpayers typically have many different NOL calculations in many different states, none of which matches the federal NOL amount.
- How does a state treat dividends from affiliates? Does it use the same percentages and stock ownership rules as the federal government? What percentage of ownership is required to obtain a dividend received deduction?

4. Income Apportionment and Allocation.

The concept of allocation and apportionment does not exist at the federal level and thus is a unique burden created by state tax laws. Over the years, states have adopted an increasingly varied set of rules for these issues. "Apportionment" generally means how the income from typical activities of a taxpayer is spread out among the taxing states. A formula is used to determine the percentage of income subject to tax in each state. Historically, an equally weighted three-factor formula consisting of property, payroll, and sales was used to determine the business activity, and thus the percentage of taxable income, that each state could claim. However,

there is currently very little uniformity among states. Other apportionment and allocation issues include:

- What items are included in the "property" factor?
- How is property valued?
- What and who is included in the "payroll" factor? Are non-cash benefits included? Is deferred compensation included? Are the salaries of the officers and directors included? To what jurisdiction is an employee's salary assigned? What if the employee has no permanent office but telecommutes, or spends all of his or her time on the road traveling between clients in five different states? Is the compensation of a taxpayer's independent contractors included?
- What is included in the "sales" factor? To what jurisdiction are sales of services and intangible property assigned?
- Do certain industries, such as manufacturing, receive a special apportionment formula, such as a single sales factor formula, as an incentive to relocate, expand, or remain in the state, and if so, how is that industry defined? Are certain industries assigned apportionment formulas different from the standard formula because of a unique business model—such as financial institutions, trucking companies, or broadcasting companies?
- When is a taxpayer required to apportion its income among all of the states in which it does business (*i.e.*, business income)? When must it allocate its income from a certain

transaction to one state (*i.e.*, non-business income)? What is the definition of business income?

- If a taxpayer must allocate its income from a certain activity to one state, which state is it? Is it the taxpayer's state of legal domicile, or the state in which it has its headquarters?

- What are the statutory rules for applying an apportionment formula that differs from the statutory formula? How does a taxpayer apply for an alternative formula and what evidence must it present? Can the state impose an alternative formula under the same theory? What types of alternatives are available?[4]

By itself, this list of questions is burdensome. But the abandonment of the "physical presence" rule compounds the burden by multiplying the number of jurisdictions in which a multistate business must resolve the uncertainties. Technology alone cannot solve the problem, because the ambiguities require human analysis and judgment. A potential taxpayer

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[4] This list of issues is not exhaustive. Added burdens stem from the cost of maintaining adequate documentation, which is multiplied as the number of taxing states increases. Further issues arise when the state tax is based on something other than income—such as assets, paid-in-capital, or gross receipts. In addition, the complexity does not end when the return is filed. Large corporations are under almost continuous audit by many states. The more jurisdictions in which the company is required to file and pay tax, the more audits to which the company will be subject. Audits require answering numerous documentation requests, conducting interviews with employees, and entering into negotiations and potential litigation. All of these items carry significant direct costs and also reduce productivity.

must answer these questions in every state and locality in which it conceivably has an economic nexus—a truly daunting task in light of the 12,600 state and local jurisdictions that have the authority to impose a business activity tax.

Without the physical presence rule, businesses must monitor every state and locality in which they have any type of commercial profile. They will be required to track state tax legislation and regulatory developments constantly, become familiar with potential changes in tax law, and stand ready to implement those changes accordingly. Studies show that state income tax compliance costs are already significant, amounting to double the costs of federal tax compliance, when computed relative to the respective tax liabilities.[5] Departures from the physical presence rule will only make the problem worse and will trigger a significant impact on interstate commerce.

C. Uncertainty Leads To Substantial Opportunity Costs

The additional compliance burdens attributable to uncertainty have real and substantial opportunity costs as well, magnifying the harm to interstate commerce. For example, a company deciding whether to expand its operations in a multistate fashion will necessarily consider whether the additional cost and complexity of tax compliance outweigh the business benefits of expansion. At the margin, the uncertainty

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[5] Sanjay Gupta and Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* 56 NAT'L TAX J. 355, 363 (2002). For the largest 1,000 firms, the ratio of state compliance costs to state income tax expenses is 2.9%, or more than twice the federal ratio of 1.4%.

caused by departures from the physical presence rule will cause companies to choose business activities that avoid compliance costs but are of lesser value to the business, society and the economy. Such a choice, inherent in any system that requires taxation, is exacerbated as the costs of compliance increase.

Such market distortions are exactly what the Commerce Clause was meant to prevent. The national economy is artificially constricted when a company does not enter new jurisdictions even though there is demand for the company's product, or does not pursue a new line of business at all because it would subject the company to the jurisdiction of additional states under a vague "economic presence" standard. The inherent uncertainty caused by departures from the physical presence rule will aggravate the distortions in economic choice.

D. The Impact on Small Businesses Will Be Severe

Although these cases deal with large corporate taxpayers, the effects on small and mid-sized businesses of abandoning the physical presence rule will be severe. Smaller businesses do not have the resources or capability to comply with the multitude of state and local tax laws that are certain to be triggered by the economic nexus standard. For example, one study determined that for firms with $5 million or more in assets, the "average total compliance costs systematically increase with increasing firm size as measured by asset size."[6] "Consistent with all earlier

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[6] Joel Slemrod and Varsha Venkatesh, *The Income Tax Compliance Cost of Large and Mid-Size Businesses: A Report to the IRS LMSB Division*, Univ. Mich. Bus. Sch. (Sept. 2002). Firms in the $5 million to $10 million asset category had an

research, compliance costs are regressive in the sense that those costs as a percentage of firm size are higher for smaller firms than they are for larger firms."[7] Thus, abandoning the physical presence rule will have a disproportionate impact on small and mid-sized corporate taxpayers.

II. ABANDONING THE PHYSICAL PRESENCE RULE FRUSTRATES THE GOAL OF ACCURATE FINANCIAL DISCLOSURE.

Departing from the physical presence rule will also create accounting difficulties and will frustrate the goal of accurate and transparent financial disclosures at the heart of the federal securities laws. A company that cannot accurately predict its state income tax liability, even internally, can scarcely be expected to provide meaningful information to investors.

The problem is made more acute by recent tightening of financial disclosure requirements. In 2006, the Financial Accounting Standards Board (FASB), adopted new rules on accounting for uncertain income tax positions. *FASB Increases Relevance and Comparability of Financial Reporting or Income Taxes: Final Interpretation Reduces Widespread Diversity in Practice*, News Release (FASB) (July 13, 2006) ("FIN 48"). FIN 48 provides uniform criteria

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average of $35,443 in compliance costs; firms in the $10 million to $50 million category spent $93,876 on average; firms with assets from $50 million to $100 million spent $149,876 on average; firms ranging from $100 million to $250 million in asset size spent an average of $243,492; and firms with $250 million to $1 billion in assets had an average of $1,331,643 in compliance costs. *Id.* at 15.

[7] *Id.*

for the preparation of financial statements and expands the disclosure required regarding uncertainty in income taxes. FIN 48 mandates a "reserve" for 100% of tax items unless it is "more likely than not" that the company will prevail in litigation on those items. This reserve is of indefinite duration, with interest and penalties accruing annually.

The abandonment of the physical presence rule along with the adoption of varying "nexus" or "economic presence" standards by different states creates havoc for the financial statements of publicly traded companies. Under FIN 48, a company with customers but no physical presence in a state or locality is required to decide whether it is "more likely than not" that it will be deemed, after the fact, to lack a requisite nexus with that jurisdiction. The ambiguous and evolving nature of the concept of "nexus" makes it extremely difficult to decide, to a 50% certainty, whether a company will be deemed to have a nexus in a given state or locality. In fact, it may very well create a never-ending dilemma for many multistate companies.

If a business determines it does not have the requisite activity to create nexus in a state and thus does not file a return there, the statute of limitations for an assessment often never expires. Thus, a business may be in the awkward position of taking a reasonable position regarding its tax filing requirements in a given state, but because of the controversial and unsettled state of the law on nexus, the business may be unable to reach the required confidence level ("more likely than not") on the validity of its financial statement reporting position under FIN 48. As a result, this phantom tax liability to the state (plus accrued phantom penalties and interest) will never disappear

from its financial statements unless the business is actually audited and the state determines it does not have nexus.

The varying and ill-defined "economic presence" standards adopted by the states will therefore frustrate the goal of providing investors with a realistic picture of a corporation's financial position. Hence, abandoning the physical presence rule disserves the purposes of the securities laws as well as the Commerce Clause.

CONCLUSION

The petitions for writ of certiorari should be granted.

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IN THE

Supreme Court of the United States

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the Supreme Judicial Court of Massachusetts

BRIEF OF *AMICUS CURIAE* INSTITUTE FOR PROFESSIONALS IN TAXATION IN SUPPORT OF PETITIONERS

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

This brief *amicus curiae* in support of Petitioner, Geoffrey, Inc. ("Geoffrey"), is filed by the Institute for Professionals in Taxation ("IPT").[1] IPT is a non-profit educational organization formed in 1976 under the laws of the District of Columbia. Its offices are located in Atlanta, Georgia. IPT's organizational purposes include the promotion of uniform and equitable administration of income, ad valorem and sales and use taxes. It has more than 4,500 members representing more than 1,400 businesses across the United States and in Canada. Represented within IPT's membership are numerous small businesses and most of the Fortune 500 companies. Member representation spans the industry spectrum, including aerospace, agriculture, manufacturing, wholesale and retail, communications, health care, financial, oil and gas, hospitality, transportation and other sectors.

Many IPT members have customers in Massachusetts and other states which have taken the position that they may constitutionally impose income and franchise taxes upon businesses that have no physical presence in such jurisdictions—

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[1] Pursuant to Rule 37.6, *amicus* Institute for Professionals in Taxation states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the submission of this brief in letters filed with the Clerk.

arguing that such businesses have an "economic nexus" with the state. Others have customers in jurisdictions considering such assertions of taxing jurisdiction through legislation or rulemaking. This issue is the most significant state and local tax question pending today. The associated tax and compliance cost implications, in the billions of dollars, are of special concern to small businesses because of the resulting disproportionate impact they occasion.

The constitutionality of the "economic nexus" theory of taxation raised here will not be resolved without this Court's intervention. The Court's declination to grant certiorari will only cause it to become a more costly and persistent issue. Conflicting state court decisions make manifest the uncertainty which attends this vital question, *to wit.*, what is the territorial limit of state taxing jurisdiction? Taxpayers and their advisors find themselves in the untenable position that the Commerce Clause, U.S. Constitution, Art. I §8 cl. 3 is being given differing applications from state to state. IPT sees the need for resolution by this Court as an urgent imperative and therefore earnestly supports Petitioner's request for review of the lower court's decision.

SUMMARY OF ARGUMENT

The decision of the Massachusetts Supreme Judicial Court below conflicts with decisions of other state courts on the question whether "economic

presence" meets the "substantial nexus" requirements of the Commerce Clause. The controversy is national in scope, the financial stakes very substantial, and the prospects for resolution without this Court's involvement extraordinarily remote. The use of an "economic nexus" standard is without precedent from this Court and premised upon speculation over the relative burdens imposed by state sales and use taxes and state income taxes. If there is a different constitutional limit to the power of state and local governments' right to impose an income tax as opposed to a sales and use tax, the difference should rest upon a principled analysis. The values which the Court found the "physical presence" standard served in *Quill* apply with equal vigor to other taxes. The Commerce Clause demands more than a superficial comparison of hypothetical "types" of taxes. It looks to the practical effects of a given tax statute upon the maintenance of an unfettered national economy. The "substantial nexus" requirement is the principal means of limiting burdens that unduly interfere with free-flowing commerce. Giving that threshold jurisdictional requirement different meanings on a tax-by-tax basis invites a proliferation of standards by state and local government anxious to expand the reach of their taxes. It would virtually assure the formulation of third, fourth and other varieties of "substantial nexus" as states, cities and counties press newly-conceived theories to justify the imposition of their levies. There are thousands of state and local jurisdictions in a position to do so, with every incentive to find a means of exporting an

augmented tax burden. The logic, simplicity and fair-mindedness of the "physical presence" requirement would be replaced by ever-finer distinctions among different taxes—taxing gross receipts, for example, would require physical presence, but a state which could not reach those receipts could tax the associated income upon the basis of "economic presence."

The "economic presence" test is nothing more than a restated Due Process test, looking to the frequency and extent of the contacts between a business and a given taxing jurisdiction. "Substantial nexus" is concerned not with the sufficiency of such contacts but with the burdens a given tax creates upon interstate commerce. Left unrepudiated by this Court, the "economic nexus" theory will effectively eradicate the requirement of "substantial nexus" except as to use taxes and will render state geographic boundaries illusory as the territorial limit on a state's taxing jurisdiction. The Court should grant the Petition and reverse the decision below.

ARGUMENT

I. Review Should be Granted to Resolve Conflicting Rulings Addressing the Question of Whether the Commerce Clause Imposes Different Jurisdictional Limitations on a Tax-by-Tax Basis.

From a short statement by this Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), a jurisdictional firestorm was born, one that will not abate without the Court's intervention. The now familiar observation concerned the "substantial nexus" requirement of the Commerce Clause:

> Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation.

Id. at 314.[2]

That remark created a conflict, the continuation of which causes the unnecessary and wasteful

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[2] Insofar as the statement concerned income taxes: (1) it was dictum—a remark about whether or not some other form of "substantial nexus" might be required for taxes not at issue in *Quill*; and (2) it was not necessary to the Court's decision. Dictum repeated, as by the Massachusetts Supreme Judicial Court, is still just dictum.

expenditure of limited business and government resources. It would be difficult to overstate the significance of the issue. It imposes upon businesses across the United States billions in tax costs which could have a substantial negative impact upon the national economy and the ability of businesses to create new jobs. Moreover, it has spawned uncertainties for state governments, the courts, taxpayers, practitioners and academics—uncertainties that confound compliance and invite litigation in state after state.

The tension between the physical presence requirement enunciated by this Court in *Quill* for sales tax purposes and the "economic nexus" theory enunciated by various state courts, is the subject of innumerable analyses and commentaries. Citing numerous state court decisions, Professor Walter Hellerstein devotes almost 40 consecutive pages to the subject in the oft-cited treatise Hellerstein & Hellerstein, *State Taxation*, ¶6.11, and refers to the "enormous outpouring of commentary" about this topic. *Id.* at ¶6.11(3), fn. 234. In addition to the many articles cited, there are numerous other legal, accounting and business periodical treatments,[3] and

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[3] See, e.g., Kulwicki, L., *Continuing State Trends in Nexus Enforcement After Quill—The Struggle to Define 'Substantial Nexus'*, 6 State Tax Notes 345 (1994); Hammack, J.M., *Taxing Out of State Entities with Intangible Assets: What Hath Geoffrey Wrought?*, 5 J. Multistate Tax'n 112 (1995); Cronin, J. et al., *Economic Nexus: A Case Study*, 14 STN 535 (1998); Langstraat, C.J. et al., *Economic Nexus: Legislative Presumption or Legitimate Proposition?*, 14 Akron Tax J. 1 (1999); Ervin, R.T., *State Taxation of Financial Institutions:*

the subject is repeatedly explored in programs sponsored by business and tax organizations and by government organizations, *e.g.*, the Federation of Tax Administrators and the Multistate Tax Commission.

More importantly for purposes of this Court's jurisdiction, there are conflicting state court decisions. The Petition does a thorough job of detailing those conflicts and it would serve no purpose to repeat that account here. IPT would only offer this additional observation—that the decisions declining to apply the physical presence test as a jurisdictional threshold for state income and franchise tax purposes rest principally upon the absence of any explicit statement from this Court that "substantial nexus" requires it. They thus reflect no principled or affirmative rationale for using one Commerce Clause standard for sales and use taxes and a diminished Commerce Clause standard for income taxes, but reflect, instead, opportunism facilitated by what is, at most, a negative implication from this Court's dictum.

Will Physical Presence or Economic Presence Win the Day?, 19 Va. Tax Rev. 515 (2000); Donnelly, G., *States of Confusion*, 16 CFO 54 (2000);); French, D., *Nexus—Between a Rock and a Hard Place on Taxes*, 38 Franchising World 51 (2006); Wells, J.T. et al., *Nexus and FIN 48: States of Flux*, 204 J. of Accountancy 80 (2007); VanLeuven, M. et al., *Economic Nexus and the Uncertainty of the Quill Physical Presence Test*, 38 Tax Adviser 322 (2007); Berger, C., *Nexus and the Need for Clarification: The Rise of Economic and Attributional Nexus*, 26 J. State Tax'n 29 (2008); Schadewalde, M.S., *FIN 48 Forces Companies to Wrestle with Uncertain State Nexus Standards*, 78 CPA Journal 42 (2008).

Typical of the reasoning is this from the Illinois appellate court's opinion in *Borden Chemicals and Plastics, L.P. v. Zehnder*, 726 N.E.2d 73, 80 (Ill. Ct. App. 2001), an income tax case:

> Plaintiff argues that in *Quill*, the Supreme Court 'left open' the question of whether a physical presence is required in order to satisfy the substantial nexus requirement in other tax cases. We disagree. As the *Quill* court noted, 'concerning other types of taxes we have not adopted a similar bright-line, physical presence requirement.' [citation omitted]. Thus, the physical presence requirement of *Quill* is inapplicable in the instant case.

A similar line of thought is found in *Bridges v. Geoffrey, Inc.*, 984 So.2d 115, 123 (La. Ct. App. 2008):

> Therefore, the language in *Quill* impliedly suggests that the physical presence requirement is limited to the area of sales and use taxes and does not apply to the

> imposition of other state taxes.

Likewise in *General Motors Corp. v. City of Seattle*, 25 P.3d 1022, 1028-29 (Wa. Ct. App. 2001), the court said of the *Quill* decision:

> The Court was careful to note, however, that in its review of other types of taxes, it has not articulated the same physical presence requirement as stated for sales and use taxes. . . . The tax at issue here is neither a sales or use tax . . . . We decline to extend *Quill's* physical presence requirement in this context.

The opinions proceed, then, from the premise that since the *Quill* decision is equivocal about the applicability of physical presence as a "substantial nexus" dictate beyond sales and use taxes, some different, and lower standard, must apply to state income taxation.[4] This approach turns what the

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[4] Florida's tack is reflective of a related tendency by some states—to treat the Court's denial of certiorari in other cases as establishing a new constitutional standard. The Florida Department of Revenue amended its corporate income tax rules after this Court declined, in late November 1993, to grant certiorari in *Geoffrey, Inc. v. So. Carolina Tax Com'n*, 437 S.E.2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993). Without any relevant change in the underlying statute, the amended rule asserted that corporations would be subject to

Court has *not* said into a new, and variable, constitutional principle that dramatically expands the states' jurisdiction to tax. It ignores the fact that there are two things that the Court has not explicitly said: it has not expressly said that physical presence is required as a jurisdictional prerequisite to the imposition of a state income tax, and it has not said that states may levy such taxes in the absence of the taxpayer's physical presence in the taxing jurisdiction. At best, from that perspective, the Court simply has not ruled upon the question, one way or the other. What is clear, however, is that all the tax cases in which this Court has found that "substantial nexus" exists, whether entailing sales, income, franchise, or other taxes, have reflected physical presence by the affected taxpayer. This is a matter the Court itself took note of in *Quill*, 504 U.S. at 310. The observation, which implies a single Commerce Clause standard for all taxes, is one which the Massachusetts Supreme Judicial Court and other lower courts have entirely disregarded.

As a corollary, the decisions accepting the "economic nexus" theory for state income taxation fail to cite instances of the Court applying different Commerce Clause standards (or other constitutional safeguards for that matter), tax-by-tax . There are numerous examples to the contrary, in which the Court has applied the same standard across tax types. The Due Process jurisdictional requirements

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Florida income tax, even in the absence of physical presence, for "selling or licensing the use of intangible property in Florida for taxable years beginning on or after January 1, 1994."

for the prescribed "minimum connections," by way of illustration, have been applied in the context of various levies. See, e.g., *Miller Brothers Co. v. Maryland*, 347 U.S. 340 (1954) (use tax), *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768 (1992) (income tax); and *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991) (Michigan Single Business Tax, a value-added tax). Similarly, the Commerce Clause prohibition against discriminatory taxation of interstate commerce has been applied, using the same standards for all tax types, to property taxes, *Camp Newfound/Owatonna, Inc. v. Town of Harrison, Me.*, 520 U.S. 564 (1997); vehicle flat taxes, *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266 (1987); gross receipts taxes, *Armco, Inc. v. Hardesty*, 467 U.S. 638 (1984); telecommunications excise taxes, *Goldberg v. Sweet*, 488 U.S. 252 (1989); sales tax, *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (U.S. 1995); intangibles taxes, *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996); and income taxes, *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984), among others. The one constant among all these cases, both state court cases and United States Supreme Court cases, is that each starts its Commerce Clause discussion with *Complete Auto*.

If the underlying basis for applying different constitutional theories to different taxes is that an income tax imposes a lesser burden than collection of use tax, that premise is totally theoretical. *Kmart Properties, Inc. v. Tax. And Rev. Dep't*, 131 P.3d 27, 35 (N.M. Ct. App. 2001). While, in *Kmart*, the court speculated about the relative burdens created by the

two taxes, speculation is not fact. There the court posits that state income taxes are usually payable once a year (ignoring requirements for estimated tax), at a single rate, to one jurisdiction, thereby suggesting such taxes reflect a lesser burden than use taxes, as described by this Court in *Quill*. There is no indication, however, that the *Kmart* court based its speculation upon any actual evidence comparing the burdens imposed by sales and use taxes with the burden imposed by state and local income taxes. The *Quill* opinion reflects no such findings or judgment.

Moreover, a compelling case can be made that the filing of state and local income tax returns and associated payment obligations is *at least* as, if not more, burdensome an obligation than the filing of state and local sales tax returns and associated collection and payment obligations. There is the obvious and very real difference that the income tax taxpayer is the obligor of the tax, not simply an agent collecting it from a customer and remitting it to the taxing jurisdiction. Comparing the burdens between the two taxes, this fact alone argues forcefully against the conclusion that collection of use tax creates the heavier burden.

Nor is it clear that subjecting a business to sales and use taxes mean that the business has to contend with more jurisdictions. One 2007 survey documented approximately 3,300 state and local tax jurisdictions that levy income, franchise and gross receipts taxes.[5] Thousands of others have the power

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[5] 'State and Local Jurisdictions Imposing Income, Franchise

to impose such taxes, and businesses would be required to gauge their amenability to such taxes based upon a multiplicity of divergent views as to what constitutes "economic nexus." The same would be true of the countless details which compliance with such taxes would demand.

State income and franchise tax requirements vary widely in such matters as types of returns (combined, consolidated, separate), parties required to join in a group return, conditions for moving from group returns to separate returns, issues arising from changes in the group (acquisitions, mergers and divestitures), types of organizations subject to tax, including issues as to partnerships, S corporations, and other pass-through entities, intercompany transactions, filing deadlines, extensions, electronic filing and payment requirements, estimated tax payments, and issues associated with federal audit adjustments and amended returns. The states use substantially different additions and subtractions to build locally-specific tax bases that vary from federal taxable income and from one another, for example, net operating loss carryovers and carrybacks. Another example is that some states "decoupled" from bonus depreciation offered at the federal level[6] while others did not.

As the Court is well aware, the states employ differing, tailored apportionment formulas to

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and Gross Receipts Taxes on Businesses, Ernst & Young, LLP, March 7, 2007".

[6] See, e.g., Fla. Stat. §220.03(3)(b) (2008).

determine their respective shares of multistate income and apply different rules for the calculation of the factor or factors used to apportion such income. Receipts to be included in the sales factor, for example, may be sourced to the jurisdiction where the costs of performance underlying the income predominate, or the receipts can be allocated among the jurisdictions where such costs are incurred, or the receipts could be sourced to the "market" jurisdiction. The components and calculation of property and payroll factors also vary from one jurisdiction to another. Apart from some regular apportionment formula, businesses may be required to contend with special industry-specific apportionment requirements, as well as demands from taxing authorities for case-by-case variations of the applicable apportionment formula(s) that such authorities believe better reflect the income properly attributable to their respective jurisdictions. The abandonment of the "physical presence" standard would subject businesses to these and thousands of additional complexities, to say nothing of the attendant audits, protests, appeals, and litigation, in jurisdictions maintaining the right to tax based upon some locally-nuanced "economic presence" test.

This analysis clearly demonstrates that there is no principled or rational basis for the conclusion that an income tax imposes a lesser burden than a sales tax. Accordingly, a different constitutional standard should not apply to an income tax than applies to a sales tax.

Furthermore, giving "substantial nexus"

different meanings, depending upon the tax being considered, is wholly illogical. Sales and use tax is surely not unique at the constitutional level. Closely related are gross receipts taxes imposed by states like New Mexico, Washington and Ohio. The New Mexico gross receipts tax is imposed upon the gross receipts of persons doing business in New Mexico, but the tax may be passed through to the consumer.[7] Even though a New Mexico appellate court adopted the "economic nexus" theory for the state's income tax, the court acknowledged that *Quill's* "physical presence" requirement governed its gross receipts tax.[8] The decision would thus interpret the "substantial nexus" prong of *Complete Auto* to require physical presence as a prerequisite to imposition of gross receipts tax, even though the business is the party being taxed and under no obligation to collect that tax from its customers. This analysis thus concedes that "physical presence" is a constitutional requirement beyond sales and use taxes—and that this jurisdictional limitation is not exclusively coupled with the responsibility of acting as a collection agent for the state.

If the Commerce Clause demands "physical presence" for the imposition of gross receipts taxes imposed upon businesses, what faulty logic would say an attenuated standard like "economic presence" suffices where other taxes imposed upon the same business are concerned? Such a rule invites the

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[7] http://www.tax.state.nm.us/oos/GrossReceiptsTaxFAQ.pdf.

[8] *Kmart Properties, Inc. v. Tax. And Rev. Dep't*, 131 P.3d 27, 35-36 (N.M. Ct. App. 2001)

implausible conclusion that a given business' income from sales into a given jurisdiction where it has no physical presence could be constitutionally taxed but that tax could not be imposed upon the gross receipts giving rise to that very income. The same business activity yields both the gross receipts and the associated income. The gross receipts are, in fact, a subset of such income.[9] Distinguishing between the two taxes, both imposed upon the business, for "substantial nexus" purposes would mean that the gross receipts fall beyond the state's taxing jurisdiction but the related income within it. If the Commerce Clause "concerns about the effects of state regulation upon the national economy" and the included requirement of "substantial nexus," which the Court has explained is "a means for limiting state burdens upon interstate commerce,"[10] embrace such unlikely distinctions, it is not because logic dictates that result.

For the same reason, the "economic nexus" contention fails to square with the Court's directive that the Commerce Clause be applied upon the basis of the "practical effect" of the tax.[11] Any fair-minded appraisal of the economic realities can lead to no conclusion other than that a gross receipts tax and an income tax are similar. The same business activity gives rise to both the gross receipts and the

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[9] See, line 1a of Form 1120, U.S. Corporation Income Tax Return, calling for the entry of "gross receipts or sales" in the calculation of taxable income.

[10] *Quill*, *supra* at 313.

[11] *Complete Auto*, *supra* at 279.

corresponding income so that the two taxes will affect such activities with equal force. The two taxes are thus alike in terms of their effect upon a free-flowing national economy. Any proposal to distinguish a use tax as an "indirect" tax (one payable by the seller only for failure to collect the same from the purchaser) from a gross receipts or income tax as a "direct" levy would be a step backwards to the type of semantic formalism the Court has clearly repudiated. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 288-89 (1977).

Finally, the sanctioning of two drastically different constitutional meanings of "substantial nexus," one for sales and use taxes and a second for state income taxes, patently invites the creation of additional jurisdictional standards for other taxes. The rationale by which an alternative standard is adopted for state income taxation would be a clear invitation to taxing agencies and taxpayers to conceptualize more rigorous or relaxed thresholds for other types of taxes, predicated upon asserted differences between the nature or quantum of burdens to which affected businesses are subjected. The proliferation of such alternative formulations, with a third "substantial nexus" test for sundry flat taxes, a fourth for a Texas Margins Tax, Tex. Tax Code §171.0001 *et seq.*, another for an Ohio Commercial Activity Tax, ORC §5751.01 *et seq.*, another for the Michigan Business Tax, MCL §208.1101 *et seq.*, and the like, is a virtually certain offspring of that first step away from the single "bright-line" test thus far articulated. The Court should grant the Petition and take this opportunity

to say what it has not made explicit to this point—that the same salutary purposes which are served by using the "physical presence" standard for state and local sales and use taxes are present when delimiting the power of state and local governments to impose income and other taxes.

II. The Alternative "Economic Presence" Test Is Unworkable, Unduly Burdens Interstate Commerce, and Renders State Boundaries Immaterial as a Limit upon the Reach of a State's Taxing Powers.

The Massachusetts Supreme Judicial Court referred to its decision of the same date in *Capital One Bank v. Commissioner of Revenue*, 899 N.E.2d 76 (Mass. 2009) as "controlling," *Geoffrey, Inc. v. Commissioner of Revenue*, 899 N.E.2d 87, 88 (Mass. 2009). The *Capital One* decision principally relies upon the analysis of the West Virginia Supreme Court of Appeals in *Tax Com'r of State v. MBNA America Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006), *cert. denied, FIA Card Services N.A. v. Tax Com'n of W. Va.*,127 S.Ct. 2997 (2007). The *MBNA* opinion did not rely upon the presence of intangibles in the taxing jurisdiction. Instead, it rejected the "physical presence" test, calling it out-of-date and held that "a significant economic presence is a better indicator of whether substantial nexus exists for Commerce Clause purposes." *Id. at 234.* As formulated by that court, the "economic presence" test "requires that an entity's contacts with the state be more frequent and systematic in nature." *Id.* The "contacts" referred to are subsequently explicated by the court as follows:

> [T]his Court has no trouble concluding that MBNA's systematic and continuous business activity [direct mail and telephone solicitation of credit card customers] produced significant gross receipts attributable to its West Virginia customers which indicate a significant economic presence sufficient to meet the substantial nexus prong of *Complete Auto*. [citations omitted]

The "economic presence" test thus would look at the contacts between the subject business and the state, rather than to the burdens imposed upon the business by the tax at issue. The substantial nexus requirement, however, is not a test of the level of contacts, no matter how frequent or systematic; the sufficiency of such contacts is the concern of the Due Process Clause. Rather, as the Court has made clear, substantial nexus is "*a means for limiting state burdens on interstate commerce.*" *Quill*, 504 U.S. at 313 (emphasis added). The analysis of the West Virginia Supreme Court of Appeals, and thus of the Massachusetts Supreme Judicial Court in *Capital One* and the instant case, adopting an "economic presence" approach, is fundamentally flawed because it forsakes any inquiry into the burden that the levied tax imposes upon the national economy.

The decision below improperly substitutes the Court's Due Process Clause test for the Commerce Clause test. The "economic presence" standard merely reaches the due process inquiry and goes no further. It therefore fails as an interpretation of that Commerce Clause prerequisite.

As this Court recognized in *Quill*, physical presence is a "bright-line rule [that] furthers the ends of the dormant Commerce Clause." 504 U.S. at 314. The test is equitable, simple for a business of any size to comprehend and predict, and easy to enforce. Importantly, the test also favors economic growth. It allows a taxpayer to report and pay taxes in fewer states, which means less money spent complying with tax laws and in litigation, and more money to invest in labor and capital. Further, it permits a business to determine with confidence, before entering a jurisdiction, whether it wants to be subject to taxation and incur the costs associated with doing business there (such as the likely need to keep multiple records, meet multiple filing requirements, and engage in multiple interactions with regulators). Our national economy plainly benefits from the relative simplicity of the bright-line physical presence rule—and that is as true of income tax statutes as of sales tax laws.

In contrast, as a practical matter, the so-called economic presence "test" is no test at all. The standard adopted by the West Virginia Supreme Court of Appeals in *MBNA* is particularly amorphous and arguably would allow for the imposition of income taxes upon mere evidence of consumers for

the services of a business, the derivation of income in any form, or even advertising directed at a state where the business has no tangible physical presence.

IPT's concern with the economic presence "test" is perhaps best demonstrated by its application to potential tax claims that its members and others are likely to face. Consider these three scenarios:

1. A professor from the University of Florida recognized as the nation's leading state and local government financing expert ("Expert") forms a consulting company to provide services to state and local governments throughout the United States. Expert never performs any services outside Florida and has no physical presence in any other state. All communications between Expert's company and its clients are performed electronically. Expert company's only contacts with states other than Florida is that its clients are located in the other states. Based upon an "economic presence" standard, in addition to Florida where Expert's company maintains physical presence, all other states where its clients are located could reasonably argue that Expert's company "systematically" and "purposefully" exploits their markets and thus has substantial nexus permitting imposition of income taxes by them.

2. A small businessman in New Jersey owns a car wash ("Car Wash") that advertises on Philadelphia radio and television stations and in Philadelphia newspapers that its rates for a car wash, detailing,

and other services are the lowest in the region. Car Wash has no physical presence in Pennsylvania. Thousands of Pennsylvania motorists pass Car Wash each weekend when headed east to the New Jersey beaches and Atlantic City, and Car Wash earns tens of thousands of dollars each year from these Pennsylvania residents. Based upon an "economic presence" standard, the Commonwealth of Pennsylvania could reasonably argue that Car Wash's "systematic" and "purposeful" efforts directed at enticing the citizens of Pennsylvania to purchase its services provides substantial nexus allowing Pennsylvania to impose income tax liability on Car Wash.

3. A neurologist at a leading hospital in Wilmington, Delaware, ("Doctor") regularly engages in remote "telemedical" examinations of stroke patients who are brought into emergency rooms in rural hospitals throughout the mid-Atlantic United States. The emergency room physicians electronically transfer patient CT scans and other data to Doctor, who reviews the materials on his computer in Delaware. Doctor and the emergency room physicians then confer by telephone or by videoconferencing link regarding diagnosis and treatment. Despite having no physical presence in any state but Delaware, all of the states where Doctor's "telepatients" are located could reasonably argue based upon an "economic presence" standard that Doctor has engaged in a "systematic" and "purposeful" direction toward those states that provides substantial nexus for income tax liability purposes.

Each of these scenarios involves an expansion of state taxing jurisdiction well beyond constitutional bounds. The resulting burdens upon interstate commerce will only increase as our national economy becomes more dependent upon the provision of information and services and as more states see the potential to expand their tax bases by adopting some variety of "economic presence" as the only limit on their taxing authority. *See e.g.*, Maine Tax Alert, Vol 18, No. 2, February 2008 ("[Maine Revenue Services] considers taxpayers with economic nexus alone to be subject to Maine's income tax laws."); and Oregon Rule 150-317.010(2) ("Substantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state.") The effects on small businesses would be particularly destructive.

Supporters of an "economic presence" standard argue that businesses benefit from the existence of a viable economic market in the states in which they have customers, and thus should be expected to pay income taxes there. This argument proves that "economic presence" is nothing more than the imposition of taxes against out-of-state business activity in exchange for the states doing what they ought to, and would be doing in any event: making their state part of the national marketplace for goods and services.

The taxation of non-resident individuals and entities is not easily restrained by political processes within the taxing state, as a state has every

incentive to export its tax burden and interpret its laws aggressively to reach as many out-of-state taxpayers as possible. The "economic presence" theory is such an attempt to ignore state boundaries in the zeal to find new revenue sources. It would effectively render the geographic limits set by a state's borders wholly irrelevant for Commerce Clause purposes where taxation is concerned.

Physical presence, by contrast, confines a state's taxing powers to its borders, circumscribing the reach of a tax to businesses that, by reason of their presence, are significantly adding costs that government would not otherwise incur. The Court should grant the Petition for the purpose of repudiating the "economic nexus" theory and making explicit the requirement of physical presence under the substantial nexus prong of the Commerce Clause.

CONCLUSION

For the foregoing reasons, this Court should grant the Petition and reverse the decision below.

Respectfully submitted,

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Supreme Court of the United States

GEOFFREY, INC.,

Petitioner,

v.

COMMISSIONER OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Judicial Court Of Massachusetts

BRIEF OF *AMICUS CURIAE* THE SHERWIN-WILLIAMS COMPANY IN SUPPORT OF PETITIONER

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STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

The Sherwin-Williams Company ("Sherwin-Williams") is an Ohio Corporation in the business of manufacturing and retailing paint and paint-related products. Sherwin-Williams is actively engaged in interstate commerce. As such, Sherwin-Williams relies on this Court's interpretation of the Commerce Clause of the United States Constitution when making business decisions and otherwise conducting itself in the interstate marketplace.

In *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977), this Court held that the Commerce Clause requires that businesses, like Sherwin-Williams, must have substantial nexus with a state for that state to impose its tax on them. Since *Complete Auto*, this Court has only defined substantial nexus once, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In *Quill* this Court reaffirmed the long-standing rule that a business must be physically present before a state may impose its tax on them: a state may only tax business that have physical presence within its

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[1] The parties were notified ten days prior to the due date of this brief of the intention to file. The parties have consented to the filing of this brief.

No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae*, its members, or its counsel made a monetary contribution to its preparation or submission.

borders.[2] The tax at issue in *Quill* was the sales tax. This Court has only interpreted what substantial nexus means in terms of the sales tax and has never specifically articulated what substantial nexus means in the area of income tax. Yet, it is as critical if not more critical to businesses like Sherwin-Williams for this Court to define substantial nexus in terms of the income tax.

This Court's silence has caused a split among the states. Some states have, rightfully in our view, applied the *Quill* physical presence rule to the income tax. However, many others have interpreted the failure of this Court to articulate a specific income tax nexus rule as license to disregard *Quill* and fashion their own rule called economic presence. Multistate businesses like Sherwin-Williams are left to navigate these uncertain waters.

Most multistate businesses like Sherwin-Williams relied on *Quill* and its ancestors in the absence of a separate ruling from this Court on state income tax nexus. In the states that have abandoned physical presence in favor of the economic presence rule multistate businesses' reliance on *Quill* is much to their detriment as it exposes them to incalculable back taxes, interest and extremely and inappropriately harsh penalties. This climate of uncertainty and potential harshness prevents multistate businesses

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[2] The *Quill* decision involved a state imposition of the duty to collect the sales tax on the business.

like Sherwin-Williams from confidently broadening the scope of their interstate activities. Therefore, not only is it in Sherwin-Williams' interest, but also the free flow of interstate commerce necessitates this Court clarify what substantial nexus means in terms of the state income tax.

SUMMARY OF ARGUMENT

In *Quill*, this Court declared "[u]ndue burdens on interstate commerce may be avoided . . . by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." 504 U.S. at 314-15. Despite this pronouncement, the lack of clear nexus rules for state income taxation resulting from this Court's silence and the corresponding split among the states has unduly burdened interstate commerce. In the absence of a clear income tax nexus rule, as demonstrated by the present case, states are not only imposing their income taxes on businesses with no physical presence but also subjecting these businesses to huge penalties for failure to file income tax returns. To lift this burden and to resolve the split among the states, this Court must articulate what substantial nexus means in terms of state income taxation.

Moreover, a clear nexus rule is even more important for purposes of state income tax than for sales tax. There is no justification for a bright-line physical presence rule only in the context of the sales tax.

Despite what some state courts and academics claim, the reality from the perspective of multistate businesses is that the complexities and compliance demands of income tax laws require greater certainty and a clearer nexus rule than sales and use tax laws demands.

Additionally, dramatic changes in the climate of interstate commerce occurring since the *Quill* decision in 1992 have raised the stakes even higher. Since *Quill* was decided, the nation has experienced several financial accounting scandals and a dramatic rise in attention to corporate financial accountability. Along with Congressional mandates like Sarbannes-Oxley, the Financial Accounting Standards Board ("FASB") has issued rules for corporate accounting increasing the stakes associated with accounting for income taxes on corporate financial statements. FASB Statement No. 109, *Accounting for Income Taxes* and its related interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), relate to the recognition of tax benefits and liabilities on a company's financial statement. FIN 48 magnifies the ill effects of the ambiguity surrounding the Commerce Clause as it applies to state income tax nexus.

As *Quill* explains, a bright-line physical presence rule allows corporate taxpayers to precisely determine whether a state may impose a tax on them and if so, to what extent the state may tax them. This principle does not only mandate a bright-line physical presence rule in the case of state sales and use tax.

Because of the complexities of income tax laws, the burdens of compliance, and the high stakes involved, a bright-line physical presence rule is absolutely critical in the case of state income tax nexus.

ARGUMENT

I. The Lack of a Clear and Distinct Income Tax Nexus Ruling from This Court Has Allowed States to Abusively Tax Out-of-State Businesses to the Detriment of Interstate Commerce.

The uncertainty surrounding state income tax nexus has allowed states to abandon long-standing rules and flippantly disregard rules articulated by this Court at the expense of interstate commerce.[3]

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[3] The Supreme Court of Appeals of West Virginia for instance wrote:

> It would be nonsense to suggest that [the Framers] could foresee or fathom a time in which a person's telephone call to his or her local credit card company would be routinely answered by a person in Bombay, India or that a consumer could purchase virtually any product on a computer with the click of a mouse without leaving home. This recognition of the staggering evolution in commerce from the Framer's time up through today suggests to this court that in applying the Commerce Clause we much eschew rigid and mechanical legal formulas [like the physical presence rule] in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense.

(Continued on following page)

Instead, with no holding from this Court dealing specifically with income tax nexus, states have creatively fashioned their own nexus rules that allow them to impose taxes on out-of-state businesses that have not even an iota of physical presence within their borders. The end result is unconstitutional discrimination against interstate commerce.

As this Court noted in *Quill Corp. v. North Dakota*, the law in the area of state tax nexus is in something of a quagmire. 504 U.S. 298, 315 (1992). This is especially true in the context of state income tax nexus. In 1977 in the case *Complete Auto*, this Court articulated a four-part test that a state's imposition of tax must meet under the Commerce Clause. 430 U.S. 247. Under the *Complete Auto* test, a state tax passes Commerce Clause muster only if: 1) the activity taxed has a substantial nexus with the state; 2) the tax is fairly apportioned; 3) the tax does not discriminate against interstate commerce; and 4) the tax is related to the services provided by the state. *Id.*, at 279. Fifteen years later in *Quill*, this Court made its only pronouncement outlining the requirements of the substantial nexus prong of the *Complete Auto* test. In the *Quill* case, the tax at issue was the sales tax. *Quill* reaffirmed the long-standing rule that substantial nexus requires that a business must be physically present before a state may impose

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Tax Comm'r of State v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006).

the burden to collect sales tax on that business. *Quill*, 504 U.S. at 317-18. Since *Complete Auto*, this Court has not heard another substantial nexus case other than *Quill*.

Geoffrey, Inc. v. Comm'r of Rev., 453 N.E.2d 87 (Mass. 2009), reflects the broader trend of states pushing the boundaries of the law in the face of uncertainty. As state budget deficits rise, states are more and more desperate to raise revenue. Common sense dictates how appealing it is for states to tax those who lack political voice allowing them to raise revenue while avoiding the political consequences of tax increases. This Court's silence in the realm of income tax nexus provides the states the perfect opportunity to do just that. Starting with South Carolina, many state courts, legislatures and departments of revenue, leaping a few logical steps and seizing upon dicta in *Quill*, adopted the theory that *Quill* applies only in the context of the sales tax. *See Geoffrey v. SC Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *see also, e.g. A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (Okla. Civ. App. 2005). This theory allowed these states to impose their income taxes on businesses with absolutely no physical presence within their borders.[4]

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[4] For example, the West Virginia Supreme Court of Appeals recently held:

(Continued on following page)

The Framers recognized that this type of abuse of power to gain a leg up in the interstate marketplace is in a state's very nature and must be checked. As James Madison wrote:

> . . . the desire of the commercial States to collect in any form, an indirect revenue from their uncommercial neighbours, must appear not less impolitic than it is unfair . . . But the mild voice of reason, pleading the cause of an enlarged and permanent interest, is but too often drowned before public bodies as well as individuals, by the clamours of an impatient avidity for immediate and immoderate gain.

> [T]he Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[a]lthough we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill*, 504 U.S. at 314, 112 S.Ct. at 1914. Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.*, 504 U.S. at 317, 112 S.Ct. at 1916. We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.

Tax Comm'r of State v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006).

The Federalist No. 42 at 284 (James Madison). By raising more revenue a state elevates its status in the interstate marketplace. A state's place in the interstate marketplace is raised even further when it attracts more businesses to become physically present within it. Raising taxes and fees on businesses with political voice (i.e. physical presence) within the state is politically difficult if not suicidal.[5] Thus, taxing out-of-state businesses is irresistibly attractive to states and they will continue to do so unless there are clear impediments imposed upon them.

The resulting harm to interstate commerce from this abuse of state power is significant. In the absence of a separate ruling on income tax nexus, the requirements of state income tax nexus under the Commerce Clause remained unclear. The states for their part, split between those states that concluded the physical presence test applies to all state taxes[6] and those that

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[5] In fact, most states offer businesses millions of dollars in incentives to stay physically present or become physically present. *See, e.g.* Tom Precious, *Uncertainty Reigns in Development Efforts*, BUFFALO NEWS, Jan. 25, 2009, at P8 (discussing the state's hand-out of $950 million dollars in incentives to businesses to locate in enterprise zones within the state in 2008 alone).

[6] For instance, in 2000, the Tennessee Supreme Court affirmed a lower court decision holding the physical presence rule applies in the context of the income tax. JC Penney Nat'l Bank v. Johnson, Comm'r of Revenue, No. M1998-00497-SC-R11_CV (Tenn. May 8, 2000) (per curiam). The New Jersey Tax Court, in this case, similarly held that the physical presence rule applies in the context of the income tax only to be later reversed

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concluded the physical presence test is isolated to sales and use tax. Until recently, more states held the view that physical presence applied to all taxes and the split among them on the income tax nexus issue was more even. Only recently, have so many states abandoned physical presence.[7] For their part, most multistate businesses like Sherwin-Williams have long relied on *Quill* and its ancestors in the absence of a separate ruling for state income tax nexus. Before a state jumped on the economic nexus bandwagon, businesses without physical presence in that state had no reason to file an income tax return in that state. This fact is of great consequence to these businesses because if a business does not file a return the statute of limitations does not begin to run in most jurisdictions. *See, e.g.* ILCS Chapter 35 § 5/905(c) (2006); N.J. REV. STAT. § 54A:9-4(c)(1)(A) (1976).

As a result and despite these businesses' reasonable reliance on *Quill* and its ancestors, such businesses

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by the state's appellate court, whose decision was later affirmed by New Jersey's highest court. Lanco, Inc. v. Director, Div'n of Tax'n, 21 N.J. Tax 200 (2003).

[7] While South Carolina started the economic presence trend in 1993, most other states did not follow suit until much more recently. *See, e.g.* Kevin Ass'ts, L.L.C. v. Crawford, 865 So. 2d 34 (Sup. Ct. La. 2004); Comptroller v. SYL, 825 A.2d 399 (Ct. of Apps. Md. 2003); Acme Royalty Co. v. Director of Revenue (Mo. Tax Ct. Jan. 3, 2002); KMart Properties, Inc. v. Taxation and Revenue Dept., 40 P.3d 1008 (N.M. 2002); A&F Trademark, Inc. v. Tolson, 605 S.E.2d 187 (N.C. 2004).

may be liable for unquantifiable back taxes and interest attributable to long ago tax years in states in which they have no physical presence whatsoever. Worse still, as the instant case demonstrates, states are eager to assess penalties for failure to file a return and for failure to timely pay income taxes due. These penalties are generally calculated as a percentage of the state-claimed back tax liability. *See e.g.* HAW. REV. STAT. § 231-39 (2007) (imposing a penalty of as much as 25% of the balance due, for the late filing of a corporate income tax return); ME. REV. STAT. ANN. 36 § 187-B(1)(C) (imposing a penalty of as much as 100% of the assessed taxes for the late payment of corporate income taxes).

This is precisely what happened to Geoffrey, Inc. in Massachusetts, even though Massachusetts law requires the abatement of penalties if the taxpayer had reasonable cause for failing to file. MASS. GEN. L. ch. 62C § 33(f). Even if the Commerce Clause does not require physical presence for a state to impose its income tax on a business, the position that it is so required is more than reasonable in the face of *Quill* and this Court's subsequent silence on the substantial nexus issue.[8] The end result is Massachusetts levying its income tax and millions of dollars in penalties on a business with no physical presence or

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[8] The fact that several states have adopted the position that physical presence is necessary for a finding of substantial income tax nexus further supports the reasonableness of Geoffrey's and similar businesses' position.

political voice within the state. Massachusetts' coffers are filled with millions of dollars while suffering virtually no political consequences and interstate commerce bears the heavy burden. This Court can ease this burden by articulating a clear rule of state income tax nexus.

II. The Burdens of Compliance with and the Complexity of State Income Tax Laws and Corporate Accounting Rules Necessitate a Clear and Distinct Income Tax Nexus Ruling from This Court.

Those that argue that the *Quill* physical presence rule is confined to the sales tax and inapplicable to the income tax cite the difference between the sales tax and income tax as justification. However, from our experience as a multistate business the differences between the two taxes actually counsel that the opposite is true: the burdens of complying with the income tax laws themselves as well as with corporate financial accountability rules dictate a bright-line income tax nexus rule is essential for states to fairly levy their income taxes on multistate businesses.

A. The Compliance Burdens Related to Income Tax Laws and Regulations Necessitate a Clear and Distinct Income Tax Nexus Rule.

While the Supreme Judicial Court of Massachusetts maintains that the *Quill* physical presence rule

is inapplicable to the analysis of the constitutionality of an imposition of the state's income tax largely because "compliance with specific administrative regulations associated with the collection of sales and use taxes unduly burdened interstate commerce, but that the collection of franchise and income taxes did not appear to cause similar compliance burdens." *Capital OneBank v. Comm'r of Revenue*, 899 N.E.2d 76, ___ (Mass. 2009). From Sherwin-Williams' perspective, this is simply not true. Sherwin-Williams is on the front lines of state tax law compliance, working every day and devoting an entire department of the company to compliance with both sales tax laws and income tax laws, as well as many other types of tax. Sherwin-Williams has first-hand knowledge that complying with state income tax laws is more burdensome than complying with any other type of tax law and income tax laws are far more complex than any other type of tax law, including sales and use tax laws. If anything, the compliance burdens associated with state income tax laws and financial accounting rules dictate that it is even more important to have a bright-line physical presence rule in the case of the income tax than it is to have such a rule in the context of the sales tax.

State courts and academics have focused on the number of returns rather than the complexity of compliance with the respective state laws and generally grossly underestimate the amount of jurisdictions to which multistate companies must file income tax returns. A typical state court justification for concluding

that compliance with state income tax laws is less onerous than compliance with state sales tax laws is because "state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. App. 2004); *see also e.g. Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W.Va. 2006); Cory D. Olson, Comment, *Following the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire That Is State Taxation*, 6 MINN. J. L. SCI. & TECH. 789, 813-14 (2005).

This is not the reality for multistate businesses like Sherwin-Williams. In many states, localities are permitted to impose their own income taxes on corporations.[9] Additionally, many income-taxing jurisdictions require multiple income tax filings each year, as well as estimated periodic filings.[10] Also, when a corporate taxpayer needs more time to file a return it generally must file an application for an extension. Sherwin-Williams files returns in approximately 170

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[9] Sherwin-Williams' home city of Cleveland, Ohio, for example, imposes an income tax on the company as do over 50 municipalities in the Greater Cleveland area alone. CLEVE. CITY INCOME TAX ORD. § 191.0101 (2004).

[10] Alabama and Idaho are just two of many examples of income-taxing jurisdictions requiring quarterly filing. ALA. ADMIN. CODE R. 810-3-82.02 (1988); IDAHO CODE § 63-3036A (2001).

state and local income tax jurisdictions on behalf of itself and its subsidiaries. As such, over the course of a typical year, the Sherwin-Williams' Tax Department files approximately 1700 income tax returns, estimated periodic payments, or applications for extensions to file returns.

Another typical argument that compliance with sales tax laws is more onerous than compliance with income tax laws is that the differences are less complex between income tax laws across jurisdictions than the differences in sales tax laws across jurisdictions. *See e.g.* John A. Swain, *State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective*, 45 WM. & MARY L. REV. 319, 368 (2003) (arguing "several key features of state corporate income taxes suggest that they are significantly less burdensome" to comply with than state sales tax laws).

From Sherwin-Williams' perspective, this is simply not true. The difference between state sales tax laws generally is limited to exemptions, rates, and the timing and manner of reporting. On the other hand, not only do jurisdictions vary in their income tax rates and timing and manner of income tax reporting, there are also countless other differences adding to the complex web of state and local income tax laws. State and local laws differ, for example, in what items qualify as non-business income, as well as allowable deductions, credits and depreciation methods. The amount of time and resources spent researching and collecting data necessary to claim

certain state or local deductions and credits alone can be staggering.[11]

Additionally, some states require combined reporting, a single return for all affiliated corporations, while others permit each corporation to file a separate return. Further complicating matters, some combined reporting states require all domestic and foreign affiliates file a single return, while others only require domestic affiliates file a single return. Also, each state has its own formula for calculating the amount of income allocable to it, known as an apportionment formula. Different states may use a different combination of three factors in their apportionment formulas: sales, payroll, and property. Some states use all three, some states use two, and some one. States also differ in what items are includable in each factor.

As a result of this greater complexity, Sherwin-Williams' Corporate Tax Department devotes significantly more of its resources to state income tax law compliance versus compliance with state sales tax

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[11] One employee in the Sherwin-Williams Tax Department estimates he spent 90 hours annually working to comply with the requirements for claiming the Ohio Refundable Jobs Credit, OHIO REV. CODE ANN. § 122.17 (2006). He spends this time coordinating with other departments within Sherwin-Williams, creating databases of information, sorting through documents, and researching changes to the required form and manner of submission of the information. According to this employee, he spends a similar amount of time working on compliance with the requirements of income tax credits for other states.

laws. Sherwin-Williams' Tax Department employs four accountants who devote their entire time on the job to sales tax law compliance. Comparatively, Sherwin-Williams' Tax Department employs seven accountants who devote their entire time on the job to income tax compliance.[12]

The only reason Sherwin-Williams needs four accountants for sales tax is the volume of returns, since sales tax returns are relatively uniform. Conversely, even though there are fewer returns to prepare, Sherwin-Williams needs seven income tax accountants to handle the complexity of income tax returns. Further illustrating the point, the Sherwin-Williams' income tax accountants are employed at a higher grade level than its sales tax accountants: Sherwin-Williams Tax Department spends 25% of its salary budget on income tax accountant salaries, while spending only 12.5% of its salary budget on sales tax accountant salaries.

Besides accountants, the Sherwin-Williams Tax Department employs five attorneys who spend the vast majority of their time addressing income tax

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[12] The income tax accountants split their time between state and federal income taxes, spending the majority of time working on strictly state issues. It is worth noting that much of the work these accountants do related to federal income taxes is also applicable to state taxes in some way, as many states base at least some of their income tax laws on federal income tax laws. Nebraska, for example, follows the Internal Revenue Code's approach to interest deduction, although with minor modifications. NEB. REV. STAT. § 77-2716 (2007).

issues. The complexity of state income tax law might be best evidenced by the fact that the Sherwin-Williams Tax Department spends a whopping 94% of its state tax litigation budget on litigating income tax issues, while it allocates merely 6% on sales tax issues.

Moreover, many states reimburse businesses a percentage of the sales tax collected from their customers as compensation for the burdens related to complying with sales tax laws. *See e.g.* FLA. STAT. § 212.12(1) (2007) (allowing businesses to retain a percentage of the sales or use tax it collects). Businesses must bear the cost of the burdens related to complying with income tax laws themselves. Additionally, businesses like Sherwin-Williams bear the cost of the income tax out of their own capital, while merely remitting funds they collect from customers to pay the sales or use tax. Accordingly, a corporation's income tax expense is deducted from its overall earnings while amounts remitted as sales and use taxes are not. This is of particular importance to multistate businesses like Sherwin-Williams, because shareholders and other investors generally gauge a corporation's health by how much that corporation earns per share.

Shareholders and investors are concerned about a corporation's state income tax expense because that corporation's effective tax rate, the amount of recognized tax expense related to the income earned

in a given year,[13] effects its earnings per share: the more income taxes a corporation is expected to pay per dollar of earnings the lower the earnings per share. Thus, shareholders and investors benefit from a precisely calculated effective tax rate because such gives them confidence in their ability to gauge the health of that corporation.

Besides benefits related to investor confidence, corporations benefit from a precisely calculated effective tax rate because such allows a corporation to know more precisely how much capital it will have available for investment, dividends, pension contributions, and salaries, as well as how its shares are priced on the public market. Lenders rely on this information to determine the corporation's debt-rating.

B. Compliance Burdens Related to Financial Accounting Rules Necessitate a Clear and Distinct Income Tax Nexus Rule.

In today's business climate, more than any other time, a bright-line income tax nexus rule is critical to the free flow of interstate commerce. Now, more than ever, multistate businesses must have the ability to determine their income tax expense as precisely as possible. To address recent financial reporting scandals and to better ensure that corporate financial

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[13] The effective tax rate is calculated as the year's recognized tax expense divided by the year's profits before tax.

statements are worthy of investors' reliance,[14] Congress, the SEC, and FASB have increased their regulation and scrutiny of financial reporting. A bright-line physical presence rule would further the aims of Congress, the SEC, and FASB in the area of financial accountability by facilitating a more precise determination of multistate corporations' state income tax expenses and effective tax rates, while the current uncertainty surrounding state income tax nexus thwarts their aims.

Of particular relevance is a recent FASB pronouncement, FIN 48. By way of background, FASB is charged with promulgating corporate accounting rules that are binding on businesses like Sherwin-Williams. One such rule is FASB Statement No. 109 *Accounting for Income Taxes* ("FAS 109"). FAS 109 provides guidelines for reporting the estimated amount of income taxes payable or refundable in a current tax year. In 2006, FASB clarified FAS 109 by issuing FIN 48 to address problems related to accounting for contingent income tax benefits.

FIN 48 limits the income tax benefits a corporation can recognize on its financial statement to those arising from tax positions "more likely than not" to ultimately be sustained. For purposes of FIN 48, an income tax position is more likely than not to be

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[14] Shareholders and other investors rely on a corporation's financial information including its reported income tax expense and effective tax rate to measure the health of that corporation.

sustained if it has a greater than 50% likelihood of being sustained on audit. The more-likely-than-not standard simply determines whether the benefit may be reported on the financial statement at all. If the benefit does not meet the more-likely-than-not threshold the company may not recognize a single dollar of the benefit on its financial statement.

If the benefit meets the more-likely-than-not standard, the company still will likely not be able to report the entire benefit on its financial report. Instead, the company may only include the portion of that benefit that is more likely than not to be sustained on audit. The company determines the reportable portion through the use of a complicated probability analysis and must make detailed disclosures of its analysis. In most cases, the end result is that companies will be able to report only a fraction of the tax benefits they expect during the tax year.

FIN 48 also requires that a corporation report potential penalties related to its tax positions as a tax liability, off-setting the benefit of that position, unless the corporation meets the statutory requirement for waiver of that penalty. In the context of state tax, this sometimes means that all potential penalties must be included on the financial statement as a liability because there is no statutory provision for waiver of that penalty.[15] This is particularly onerous because

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[15] In Alaska, for example, penalties may only be waived in the discretion of the Department of Revenue or the Attorney

(Continued on following page)

under current conditions, as discussed above, states may potentially impose enormous penalties on corporations with no physical presence within the state.

For these reasons, the ambiguity surrounding the issue of state income tax nexus interferes with corporations' abilities to conduct themselves in the interstate marketplace. The more uncertainty surrounding an income tax position, the less likely it is that a corporation may recognize the benefit from such a position on its financial statement under FIN 48. As a result, the financial statement may reflect lower earnings per share than reality dictates. Combined with the fact that FIN 48 also requires that corporations reserve for potentially enormous penalties resulting from this uncertainty, until the law in this area is clear, corporations will also likely have less available capital for investment. Finally, the potential liability for incalculable back taxes, interest and substantial underpayment penalties, alone, is enough for businesses to think twice before expanding operations interstate.

A clearly articulated physical presence rule for state income tax nexus would go a long way to furthering the ends of FIN 48. Such a rule would reduce uncertainty related to multistate businesses'

General. ALASKA STAT. § 43.05.070 (2006). Therefore, there is no statutory provision for waiver of the penalty and a company must account for all potential Alaska penalties on its financial report.

state income tax positions resulting in a more realistic report of multistate corporations' income tax expense, effective tax rate, and earnings per share.

CONCLUSION

For these reasons, The Sherwin-Williams Company respectfully requests that this Court grant Geoffrey, Inc.'s petition for a writ of certiorari and reverse the decision of the Supreme Judicial Court of Massachusetts.

Respectfully submitted,

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GEOFFREY, INC.,
Petitioner,

v.

COMMISSIONER OF REVENUE,
Respondent.

On a Petition for a Writ of Certiorari to the Massachusetts Supreme Judicial Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.[1] Tax Executives Institute (herein-

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.2(a), counsel of record for both parties received timely notice of the intent to file an *amicus* brief under this rule and both par-

after "TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

TEI has more than 7,000 members who represent more than 3,200 of the leading corporations in the United States, Canada, Europe and Asia, including many domiciled or doing business in Massachusetts. TEI members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. Because TEI members and the companies by whom they are employed will be materially affected by the Court's disposition of the constitutional issues raised by this case, the Institute has a special interest in this matter.

SUMMARY OF ARGUMENT

The issue presented in this case is whether the Commerce Clause precludes Massachusetts and other States from taxing the income of a corporation whose presence in the State is not physical, but involves only the use of its trademark (or other intangible property) by a licensee. For the past 40

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ties have consented to its submission in letters filed with the Clerk.

years, taxpayers have relied upon the bright-line constitutional principle that an enterprise must have physical presence in a State before being subject to tax in that State. In *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), the Court held that an interstate business without any physical presence in Illinois did not have a sufficient connection, or nexus, with the State to require the business to collect and remit use taxes on sales made to Illinois customers. Twenty-five years later, it affirmed that holding in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). There, the State of North Dakota challenged the continuing validity of the Court's holding in *National Bellas Hess* arguing that a physical presence standard no longer reflected the realities of an evolving marketplace so altered by changes in technology and other commercial innovations. This Court was unpersuaded. Noting the importance of adhering to precedent, the Court in *Quill* upheld the physical presence test, vindicating the Commerce Clause and simplifying tax administration for business taxpayers and tax administrators. The intervening decade and a half has brought numerous challenges to the physical presence standard, the most recent one being this case.

1. The Massachusetts Supreme Judicial Court concluded that "substantial nexus can be established where a taxpayer domiciled in one State carries on business in another State through the licensing of its intangible property that generates income for the taxpayer." *Geoffrey, Inc. v. Massachusetts Department of Revenue*, 453 Mass. 17, 23 (2009). The lower court based that decision on its opinion earlier that same day in *Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1 (2009), where it construed the "substantial nexus" standard in *Complete Auto Transit, Inc. v.*

Brady, 430 U.S. 274, 279 (1977), to vitiate the physical-presence standard articulated in *National Bellas Hess* and reaffirmed in *Quill*.[2]

2. Concluding that *Complete Auto Transit* and *Quill* establish differing nexus standards -- with the former overruling the latter – is simply wrong. In formulating its four-prong test for determining whether a state tax statute violates the Commerce Clause, the Court in *Complete Auto Transit* harmonized its decisions from earlier cases. Indeed, the first prong of the *Complete Auto Transit* test requiring substantial nexus was expressly based on the Court's previous holdings, which include *National Bellas Hess*. The Court's later holding in *Quill* did not produce a new or different standard; it affirmed and vivified the existing standard – physical presence in a State.

3. The Massachusetts court misapprehended this Court's decisions in *Quill*, *Complete Auto Transit*, and *National Bellas Hess* in other important respects: First, it erroneously concluded that the bright-line, physical presence test embraced by the Court for Commerce Clause purposes has no application in respect of income taxes. Moreover, by conjuring nexus between a licensor and the State from a *licensee*'s use of a trademark, the lower court set forth a standard so open-ended – so untethered to principle – that it can only subvert the core purpose of the Commerce Clause.

Massachusetts is not alone in its attempt to expand its tax base by chipping away at the physical pres-

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[2] The *Capital One* case is also before the Court. *See Capital One Bank v. Commissioner of Revenue*, 453 Mass. 1 (2009), *petition for cert. filed* (March 19, 2009) (08-1169).

ence test. Numerous other States have striven to legislatively, judicially, or administratively diminish *Quill* and *National Bellas Hess* by asserting that they apply solely to sales and use taxes. They make this claim even though this Court has never permitted the imposition of a state tax upon a nonresident enterprise without some in-state physical presence.

4. Making matters worse, the amorphous nexus standards conjured by the States provide near complete discretion to the States in making nexus determinations. This growing lack of clear and objective standards threatens the ability of all businesses – no matter how small and no matter where located – to engage in interstate commerce without the imposition of undue burdens. If the reliance interests of multistate businesses are to be reordered by a standard other than that defined in *Quill* and *National Bellas Hess*, that change should be effected by Congress exercising its plenary power under the Commerce Clause.

ARGUMENT

I. BACKGROUND

In 1984, Toys "R" Us, Inc. formed the petitioner, Geoffrey, Inc., under Delaware law as a wholly owned subsidiary to hold several trade names, service marks and trademarks, including "Toys 'R' Us" and the Geoffrey the Giraffe character. Geoffrey, Inc. ("Geoffrey") licensed those intangible assets to affiliated companies and to certain third parties located throughout the United States. The license agreements provided for market-rate royalties for the use of Geoffrey's intangible assets.

In Massachusetts, Geoffrey licensed its trade names and trademarks to two affiliated entities: Toys "R"

Us-Mass, Inc. ("TRUMI") and Baby Superstore, Inc. TRUMI operated retail stores located in Massachusetts and Baby Superstore operated retail stores across the United States including Massachusetts through its Babies "R" Us division. In return for the right to use its intellectual property, TRUMI and Baby Superstore remitted royalty payments to Geoffrey based on their net sales.

Geoffrey itself had no property or employees located in Massachusetts. Additionally, Geoffrey never used state or federal courts located in Massachusetts. The only connection Geoffrey had with Massachusetts was the licensing of its trademarks and trade names to TRUMI and Baby Superstore for use at stores located in Massachusetts.

During an audit of TRUMI's Massachusetts corporate excise tax return, the Massachusetts Department of Revenue initiated a nexus investigation into Geoffrey's activities in Massachusetts. It did not challenge that Geoffrey was formed for a valid business purpose or had economic substance. After analyzing Geoffrey's activities, however, the Department determined that Geoffrey was subject to the corporate excise tax as a result of its "economic presence" in the Commonwealth. Geoffrey appealed this determination to the Massachusetts Appellate Tax Board. Finding that so-called economic presence alone created nexus in the Commonwealth, the Board found in favor of the Department. Geoffrey appealed this decision, and the Massachusetts Supreme Judicial Court affirmed.

II. THE COMMERCE CLAUSE REQUIRES PHYSICAL PRESENCE BEFORE A STATE CAN IMPOSE A TAX ON INTERSTATE BUSINESSES

The core issue presented is whether TRUMI's and Baby Superstore's use of Geoffrey's intangible property in Massachusetts subjected Geoffrey to income tax in the Commonwealth. The Massachusetts court boldly asserts the answer is yes, contending that taxpayers cross the Commerce Clause's nexus threshold by merely licensing intangible property to persons in Massachusetts. *Geoffrey, Inc. v. Massachusetts Department of Revenue*, 453 Mass. 17, 23 (2009). Thus, it vitiated existing Commerce Clause restraints by holding that nexus for state income taxes "is determined not by *Quill*'s physical presence test, but by the 'substantial nexus' test articulated in *Complete Auto*." *Id.* at 18 (citing *Capital One Bank*, 453 Mass. at 15 (2009)). The holdings of the Massachusetts court in *Capital One* and the instant case cast an ominous shadow over the protections accorded interstate businesses by the Commerce Clause of the Constitution.

The Commerce Clause provides that "[t]he Congress shall have Power . . . To regulate Commerce with foreign nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3.[3] The "fundamental purpose" of the [Commerce] Clause is to assure that there be free trade among the several States." *Boston Stock Exchange v. State*

[3] "Although the language of th[e] Clause speaks only of Congress' power over commerce, the Court long has recognized that it also limits the power of the States to erect barriers against interstate trade." *Dennis v. Higgins*, 498 U.S. 439, 446 (1991) (internal quotation omitted).

Tax Commission, 429 U.S. 318, 335 (1977). In tandem with the Due Process Clause of the Fourteenth Amendment, the Commerce Clause acts to prevent the States from enacting unfair tax or tax collection statutes and thereby imposing "unreasonable clog[s] upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court established a four-prong test for determining whether a state tax statute violates the Commerce Clause – that is to say, whether it impermissibly reaches extraterritorial values. Specifically, a tax will be sustained only if (1) it is applied to an activity with a substantial nexus with the taxing State, (2) it is fairly apportioned, (3) it does not discriminate against interstate commerce, and (4) it is fairly related to the services provided by the State. *Id.* at 279. The Court noted that it was not breaking new constitutional ground in articulating its four-pronged test. Rather, it merely synthesized extant Commerce Clause jurisprudence as it related to state tax systems. *Id.* at 279.

One progenitor of the substantial nexus prong of the *Complete Auto Transit* test was the Court's 1967 decision in *National Bellas Hess, Inc. v. Department of Revenue of Illinois*, 386 U.S. 753 (1967), in which it held that a sales and use tax violated the Commerce Clause to the extent it was imposed on a vendor whose only contacts with the taxing State were through the mail and by common carrier.[4] The Court

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[4] The Court also reasoned that the administrative and record-keeping requirements that could arise in the absence of a physical presence test "could entangle National [Bellas Hess]'s inter-

explained that permitting the imposition of a use tax collection duty on a business that maintained no physical presence in the State would give rise to "unjustifiable local entanglements" of interstate commerce. *Id.* at 760. Evaluating earlier cases, the Court noted it had "never held that a State may impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail [*i.e.*, without physical presence in the State]." *Id.* at 758. That remains true today.

Twenty-five years after *National Bellas Hess*, in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court again grappled with the question whether physical presence was required before a State could constitutionally impose a use tax collection obligation on an out-of-state enterprise. The State of North Dakota argued that the physical presence standard had outlived its usefulness, its obsolescence caused by "tremendous social, economic, commercial, and legal innovations" since *National Bellas Hess* was decided in 1967. *North Dakota v. Quill Corp.*, 470 N.W.2d 203, 208 (N.D. 1991). The Court declined, however, North Dakota's invitation to cast aside more than 25 years of precedent simply because States found the economic effects of the Commerce Clause not to their suiting. Indeed, *Quill* confirmed the vitality of the *Complete Auto Transit* construct and effectively harmonized that decision with the Court's 1967 decision in *National Bellas Hess*. It also reaffirmed the constitutional prerequisite of the taxpayer's physical presence in the taxing jurisdiction. *Quill Corp.*, 504 U.S. at 317.

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state business in a virtual welter of complicated obligations to local jurisdictions . . . ." *Id.* at 759-60.

Thus, *Quill* vivified the principle that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the substantial nexus required by the Commerce Clause. The Court embraced *National Bellas Hess*'s bright-line physical-presence test of Commerce Clause nexus not only because such a test "furthers the ends of the dormant Commerce Clause" by "demarcati[ng] . . . a discrete realm of commercial activity that is free from interstate taxation," *id.* at 315, but because it fosters the "interest in stability and orderly development of the law" that undergirds the doctrine of *stare decisis*. *Id.* at 315 (quoting *Runyon v. McCrary*, 427 U.S. 160, 190-91 (1976) (Stevens, J., concurring).[5] The Court in *Quill* did not explicitly extend its holding beyond the sales and use tax area, but it cautioned that its declining to articulate a physical-presence test in other areas "does not imply repudiation of the [*National*] *Bellas Hess* rule" in those areas. *Id.* at 314.

The similarities between this case and *Quill* are striking. As was the case with the North Dakota Supreme Court in *Quill*, the Massachusetts Supreme Judicial Court in the instant case has brushed aside years of binding precedent on a results-oriented quest to constrict the Commerce Clause. Mimicking the brash approach of North Dakota's Supreme Court, Massachusetts here argues that the physical presence standard should no longer apply to income taxes, intimating that advancements in technology and evolution of the interstate market have rendered

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[5] "[T]he continuing value of a bright-line rule in this area and the doctrine and principles of *stare decisis* indicate the [*National*] *Bellas Hess* rule remains good law." *Quill Corp.*, 504 U.S. at 317.

the physical presence test obsolete.[6] Indeed, the Commonwealth effectively argues that the bright-line physical presence test outside of the sales and use tax context should be jettisoned simply because it does not like the results when that standard is applied to the licensing of intangible assets to persons in Massachusetts.[7]

The approach taken by Massachusetts was born of its frustration with the restrictions imposed by the Commerce Clause to minimize burdens on interstate commerce. Other States too have sought to jettison physical presence as the *sine qua non* for nexus in favor of an elastic economic nexus standard that defies practical and predictable application. In fact, the Massachusetts court justified its decision, in part,

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[6] At the time *Quill* was decided, 36 States had enacted legislation essentially disregarding this Court's holding in *National Bellas Hess*. While some statutes were contingent on intervening federal legislation or other federal authority, others flew in the face of this Court's precedents. Alabama, for example, deemed the U.S. Postal Service to be the seller's agent, even though *National Bellas Hess* clearly states that the use of common carriers or the mails does not provide sufficient nexus for Commerce Clause purposes. 386 U.S. at 758; *see* Alabama Code § 40-23-1(a)(5) (Supp. 1990).

[7] Massachusetts has made several attempts to collapse intercompany transactions between in-state and out-of-state enterprises. The Massachusetts Department of Revenue issued Directive 96-2 on July 3, 1996 informing taxpayers of its view that out-of-state corporations receiving royalties from in-state licensees are subject to the corporate excise tax. Massachusetts Department of Revenue, Directive 96-2 (July 3, 1996). In 2003, the Massachusetts legislature enacted related party "add-back" provisions that deny deductions for certain royalty and interest payments made by Massachusetts taxpayers to affiliated entities. *See* Mass. Gen. Laws ch. 63, §§ 31I and 31J (effective for tax years beginning on or after January 1, 2002).

by saying "everybody else is doing it": "In reaching this conclusion, we join other jurisdictions that have considered the physical presence issue in the context of intangible property and have upheld the imposition of income-based tax assessments." *Geoffrey*, 453 Mass. at 23-24. Without analysis, the court summarily dismissed the well-reasoned opinions of state courts that have followed established precedent by concluding physical presence remains the standard for state tax Commerce Clause nexus inquiries. *See, e.g., Guardian Industries Corp. v. Department of Treasury*, 499 N.W.2d 349, 353 (Mich. Ct. App. 1993); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000); *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999).

In dismissing *Quill*, the Massachusetts court gave short shrift to a basic principle of constitutional adjudication: It is this Court that prescribes constitutional standards and the lower courts are obliged to adhere to those standards. *Cooper v. Aaron*, 358 U.S. 1, 18 (1958); *The Mayor v. Cooper*, 73 U.S. (6 Wall.) 247, 253 (1867). The decision below thus stands not only as a repudiation of the bright-line test set forth in *Quill*, but as an affront to the Court itself.

In *Flood v. Kuhn*, 407 U.S. 258, 283-84 (1972), Justice Blackmun gave voice to the Court's well-founded unwillingness to interfere with commercial relationships developed in reliance upon a decision of this Court. "If there is any inconsistency or illogic in all this," he wrote for the Court, "it is an inconsistency and illogic long standing that is to be remedied by Congress and not by this Court." *Id.* at 284. It certainly is not to be "remedied" by inferior courts in defiance of this Court's holdings in *National Bellas Hess* and *Quill*.

Amicus TEI respectfully suggests that if *National Bellas Hess* and *Quill* are to be dispatched – if the commercial relationships developed in reliance upon those decisions are to be upended – it is for Congress to decide. "[O]nly Congress has both the ability to canvass the myriad facts and factors relevant to interstate taxation and the power to shape a nationwide system that [will] guarantee the States fair revenues and offer interstate business freedom from strangulation by multiple paperwork and tax burdens." *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 331 (1982) (O'Connor, J., with Blackmun & Rehnquist, J.J., dissenting).

Justice Frankfurter explained the quandary confronting the Court in his dissenting opinion in *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959):

> At best, this Court can only act negatively . . . . We cannot make a detailed inquiry into the incidence of economic burdens in order to determine the extent to which such burdens conflict with the necessities of national economic life. Neither can we devise appropriate standards for dividing up national revenue on the basis of more or less abstract principles of constitutional law, which cannot be responsive to the subtleties of the interrelated economies of Nation and State.
>
> The problem calls for solution by devising a congressional policy. Congress alone can provide for a full and thorough canvassing of the multitudinous and intricate factors which compose the problem of the taxing freedom of the States and the needed limits on such state taxing power.

Id. at 476 (Frankfurter, J., dissenting).

Significantly, Congress exercised its legislative authority in the aftermath of the Court's decision in *Northwestern States Portland Cement*, enacting Public Law No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. § 381 (1988)). *Amicus* TEI submits that if, after over 40 years, the standard enunciated in *National Bellas Hess* is to be modified, that decision belongs to the national legislature. Indeed, Congress's failure to enact such legislation – notwithstanding repeated attempts – underscores the impropriety of the decision below and why the reliance interests of taxpayers should not be upended by overturning long established precedent.

III. STATES ARE BOUND BY COMMERCE CLAUSE LIMITATIONS RESULTING FROM TAX POLICY CHOICES MADE BY STATE LEGISLATURES

The decision below is a consequence not of an antiquated constitutional standard, but of the tax policy choices made by the Massachusetts legislature.

Within boundaries established by the Commerce Clause and Due Process Clause, a State is free to construct its own taxing system. U.S. Const. art. I, § 8, cl. 3 and U.S. Const. amend. XIV, § 1. Some States have chosen to adopt taxing regimes under which a taxpayer's entire unitary group of corporations is required to be included in a single combined corporate tax report. *See e.g.*, California (Cal. Rev. & Tax Code § 25101); Maine (Me. Rev. Stat. Ann. § 5220(5)). Under a unitary combined system, all members of a unitary group of taxpayers (including those without nexus in the State) are included in a combined report and intercompany transactions between group members are eliminated. Other States have enacted systems under which each corporation

must file a separate state return regardless whether the corporation files a consolidated federal return. *See e.g.,* Maryland (Md. Code Ann. Tax-Gen. § 10-811); Pennsylvania (72 P.S. § 7404).

Massachusetts, as is its right, has adopted a state taxing regime that imposes corporate income tax liability on a "separate company" basis.[8] A direct consequence of that policy choice is the requirement that Massachusetts must recognize the separate existence of individual corporations and the transactions between them. Thus, during the years at issue, TRUMI and Baby Superstores filed "separate company" tax returns where they calculated Massachusetts taxable income based on their separate company financial results as required by Massachusetts law. Mass. Gen. Laws ch. 63, § 32B (2008).

Having established its tax system, Massachusetts cannot pick and choose whether to respect certain transactions or entities – or to disregard *Complete Auto Transit*'s substantial nexus requirements – simply because it does not like the results. A different tax policy choice – one requiring a combined return for all members of a unitary group – would have yielded a different result. But that is not the choice Massachusetts made.[9]

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[8] *See* Massachusetts Department of Revenue, Technical Information Release No. 08-11 (August 15, 2008). Under the separate reporting regime in place during the periods at issue in this case, however, "each corporation with nexus files a tax return that includes only the separately-determined income and apportionment factors of that corporation." Massachusetts Department of Revenue, Technical. *Id.*

[9] Massachusetts has since moved to a corporate excise tax system that requires affiliated groups of unitary corporations to file a combined excise tax return. *See* Massachusetts De-

In an earlier case involving a similar fact pattern, the Massachusetts Supreme Judicial Court recognized that "our tax system is a rule-based system, objective in nature, that places principal importance on what taxpayers do and the economic consequences attached to those actions, not on what may have subjectively motivated them to act in the first place." *Sherwin-Williams Co. v. Commissioner of Revenue*, 778 N.E.2d 504, 514 (Mass. 2002). In that case, the court upheld the deductions of a Massachusetts taxpayer for royalties paid to a non-Massachusetts entity for the use of intangible property in Massachusetts against allegations by the Massachusetts Department of Revenue that the transactions should be disregarded as sham transactions. Such an argument would not have been necessary if the licensor had nexus in Massachusetts.

In 2008, the Massachusetts legislature passed legislation requiring all members of a unitary group of affiliated corporations to file a single combined corporate excise tax return. Mass. Gen. Laws ch. 63, § 32B (effective January 1, 2009). The unitary group also includes entities that do not have nexus in Massachusetts. All transactions between members of the group are eliminated in the calculation of the group's Massachusetts taxable income. Massachusetts Department of Revenue, Technical Information Release No. 08-11 (August 15, 2008). Thus, the legislature in Massachusetts has acted to establish a constitutionally sound taxing system that eliminates the transactions between affiliated in-state licensees and out-of-state licensors. That it did not do so earlier is no basis for upending the physical presence test.

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partment of Revenue, Technical Information Release No. 08-11 (August 15, 2008).

IV. ABANDONING THE BRIGHT-LINE PHYSICAL PRESENCE TEST WOULD SPAWN A STANDARDLESS MORASS OF STATE NEXUS RULES, THEREBY UNDERMINING THE FUNDAMENTAL PURPOSE OF THE COMMERCE CLAUSE

The Massachusetts court's elastic economic nexus standard is so amorphous that it robs taxpayers of the certainty promised by *National Bellas Hess* and *Quill* and grants license to States to tax at will because a business's "defense" of a particular nexus-causing factor cited by the State would be met by the creation of yet another one. For example, could the mere licensing of software to residents of a State, without more, subject an out-of-state business to an income tax payment obligation?[10] Could cashing a check drawn on an in-state bank, without more, satisfy the Commerce Clause? Would the answer be any different if the out-of-state business engaged in direct solicitation of in-state customers? Or if it engaged in business only through advertisements in general circulation periodicals? Or if its television or radio advertising originated outside the State?[11]

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[10] The Iowa Department of Revenue has promulgated a regulation providing that licensing software to businesses located in Iowa creates nexus in the State. *See* 701 I.A.C. § 52.1(4), Example 7. *See also* Iowa Department of Revenue, Policy Letter 08240032 (May 14, 2008).

[11] In Wisconsin, the legislature recently enacted legislation expanding the definition of nexus to include:

> regularly soliciting business from potential customers in this state; regularly performing services outside this state for which the benefits are received in this state; regularly engaging in transactions with customers in this state that involve intangible property and result in receipts flowing to the taxpayer from within this state; holding loans se-

Undoubtedly, the Massachusetts Department of Revenue would point to the State's statutory definitions of "doing business" in the Commonwealth as the starting point. The question, however, is not whether the States choose to tax such activity but whether the Constitution permits such a tax. *Amicus* TEI submits that the "substantial economic presence" test crafted by the Massachusetts court is more pernicious than the "slightest presence" test that this Court properly rejected in *National Geographic Society v. California Board of Equalization*, 430 U.S. 551, 556 (1977). After all, in *National Geographic* the business had some physical presence in the State, albeit unconnected with the transactions giving rise to the use tax obligation. Here, there is nothing but conjured presence and trumped-up nexus.

Stated simply, abandoning the bright-line test of *National Bellas Hess* and *Quill* could leave the States free to wield "economic presence" as a shibboleth to eviscerate the Commerce Clause's nexus requirement. The scope and meaning of the term "nexus" would change from case to case, to suit the needs, wants, and wishes of the taxing jurisdiction.[12] And, it would provide no guidance to taxpayers or tax administrators, and thus would guarantee, not the

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cured by real or tangible personal property located in this state.

Wis. Stat. § 71.22(1r) (effective January 1, 2009).

[12] In other words, the nexus requirement would become little more than the word "glory" in *Through the Looking Glass*: meaning whatever the States, like Humpty Dumpty, say it means. *See* Lewis Carroll, *Through the Looking Glass*, 186 (Signet Classic 1960) ("'When *I* use a word ['glory']," Humpty Dumpty said, in a rather scornful tone, "it means just what I choose it to mean – neither more nor less."').

free flow of commerce, but only contention and dispute. There would be no stability. There would be no predictability. There would be no free flow of commerce. And the fundamental purpose of the Commerce Clause – ensuring free trade among the States – would consequently be undermined.

The lower court identified "intangible property" within the State generating income for the taxpayer as justifying its conclusion, but in fact, Geoffrey itself engaged in no business activity within Massachusetts. Indeed, the lower court's standard is so broad that it would sweep an extraordinary amount of out-of-state businesses within its taxing net. Consider what would give rise to tax and who would be taxable under the lower court's analysis. Every sale of a Mickey Mouse T-shirt, a personal computer with Microsoft's Windows software installed and "Intel inside," or every iPod with downloaded music would give rise to a royalty or licensing fee subject to tax. To avoid being caught in this expansive net, Geoffrey would need to instruct children to refrain from mentioning that they "want to be a Toys "R" Us kid." Indeed, whenever one person's intangible property (be it a copyright, trademark, trade name, patent, or some similar property) was used by others, the person would be subject to tax and – to the attendant filing and compliance costs – where the property was used, regardless of whether the person had any say in the matter.

The Massachusetts court's jurisdictional alchemy would massively expand the obligation of taxpayers to comply with a plethora of state tax filing obligations. Businesses that received income from other persons' use of their intangible property would have to monitor where such property was used, determine

what part of the income derived from such use was attributable to which jurisdiction, research the tax consequences of such use in each jurisdiction, and then undertake to comply. They would likely have to revise their licensing agreements, change their accounting systems to capture the necessary information, and set in place procedures to ensure compliance with myriad filing and reporting requirements. None of these tasks would be easy, and none would be cheap. The burden of uncertainty, exacerbated by the cost of good faith compliance efforts, could not help but act as an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. at 527 (1935).

It was concerns with administrative costs and burdens that informed the Court's Commerce Clause analysis in *Quill* and in *National Bellas Hess*, and such concerns that led the Court to affirm the vitality of the physical-presence test in respect of sales and use tax. Such concerns, regrettably, were lost on the court below. A writ of certiorari should be issued to remedy that shortcoming by confirming the application of a bright-line, physical presence test to income tax cases.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

Respectfully submitted,

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